

OUTLINES OF ECONOMICS

PART II

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CONTENTS

BOOK IV.

CHAPTER I.

Money.

Importance of the Monetary System, 1 ; History of Money, 2 ; Commodity Money, 3 ; Characteristics of good commodity Money, 3 ; Functions of Money, Definitions of Money, 9-12 ; Money (a) in the narrow sense (b) and in a wide sense, 9 ; Coinage and Currency, 12-16 ; The Kinds of Money—Standard Money, Token Money, Credit Money, Legal Tender Money ; Metallic Money as Standard Money, Paper Money as Standard Money ; Some important monetary questions, 16-22 ; Measurement of changes in the value of money—Index Numbers, 16 ; Purposes for which Index Numbers are used—, 17 ; How to construct a table of Index Numbers—general rules, 17 ; Limitations of Index Numbers, Practical and other difficulties relating to the construction of Index Numbers, 20 ; How the Value of Money is determined, 22- ; The causes which bring about changes in the value of money—how the value of money is determined. Theory about the value of Money, 22 ; The Demand and Supply Theory about the value of Money, 22 ; Determination of (a) the Value of Money and (b) the Value of other Commodities—Similarity and Difference, 24 ; The Quantity Theory about the value of Money, 26-43 ; The cost of the precious metals (specie) in relation to their value, 34 ; Prof. Marshall on the value of a country's currency and the relation between the volume of the currency and the general level of prices, 36 ; Symbolical expression of the theory of the value of money, 37 ; Effects of changes in the Value of Money, 46-51 ; Changes in the value of money—depreciation and appreciation, Inflation and deflation, 43 ; Are rising, falling or steady prices the best? 51 ; Falling Prices and the World Economic Depression, 56 ; Proposals to raise the price level in different countries and the world price level and then to stabilize the price level. The World Economic Conference in relation to the raising of the price level and also restoring exchange stability between the currencies of different countries,

56-57 ; The circulation of Money—Gresham's Law, 58-62 ; Systems of Metallic Currency—The Question of the Standard, Monometallism (the Single Standard), Bimetallism (or the Double Standard), and the Gold-Exchange Standard, 63 ; Different ways of combining gold and silver in the currency system of a country, 63 ; Decline of Bimetallism, 64 ; Triumph of Gold Monometallism in pre-war Europe, 64 ; Restoration of the Gold Standard in Britain and in many countries after the War, 65 ; The Question of the Standard, 66 ; Bimetallism (the Double Standard), 66-74 ; The Arguments usually urged in favour of Bimetallism, 66 ; Some Arguments usually advanced against Bimetallism, 69 ; Bimetallism and the World Economic Depression, 73 ; Monometallism (The Single Standard), 74-78 ; Arguments against Monometallism, 74 ; The case for Gold Monometallism—The arguments in favour of Gold Monometallism, 75 ; Two important types of the Gold Standard—(1) the Gold Standard with a Gold Currency and (2) the Gold Bullion Standard, 76 ; Britain introduces the Gold Bullion Standard in 1925. The Gold Bullion Standard proposed for India in 1926, 77 ; The Gold Exchange Standard, 78- ; Recent abandonment of the Gold Standard by Britain and many other countries. The Sterling Standard in Britain and the Sterling Exchange Standard in India to-day, 79 ; The Proposed Sterling Bloc, 89 ; The International Gold Standard before its recent abandonment, 81 ; Paper Money, 84 ; Three kinds of paper money, 86 ; Whether the creation of paper money is equivalent to the creation of wealth, 87 ; Advantages of paper money, 88 ; Disadvantages of paper money, 88 ; Inconvertible paper (irredeemable paper) money, 90 ; Advantages, 90 ; Evils of irredeemable paper, 90 ; Convertible paper currency, 93 ; Government convertible paper—Advantages, 94 ; Convertible bank paper, 94 ; The ideal currency of economists—a regulated paper currency, 96 ; International paper money, 96 ; Safeguards for the regulation of the note issue, 96 ; The banking theory and the currency theory of note issue, 96 ; International Distribution of Money, 96 ; By what means is the transfer of bullion from one country to another prevented in a large degree? 98 ; Gold movements, 98 ; Money and the world factor, 100 ; The essentials of a good monetary system, 100 ; The advantages which a country derives from a good monetary system, 100.

CHAPTER II.

Credit and Banking.

What is credit? 103 ; Two forms of credit, 103 ; Can credit create capital? 103 ; Advantages of credit, 104 ; Evils of credit, 105 ; Mechanism of credit—credit and its organization, 105 ; Credit Instruments, 106 ; The cheque, 106 ; The bill of exchange, 106 ; Credit Institutions—Banks and Clearing Houses, 107 ; Functions exercised by banks, 108 ; Definition of a bank, 111 ; Modern Banking Operations, 111- ; Deposits (a) cash deposits (b) credit deposits. Credit manufacture by banks—how the banks create credit, 113 ; Creation of credit in the form of bank notes, 113 ; Creation of credit in the form of credit deposits (and cheque currency based upon them). Loans make deposits, 113-114 ; Discount, 117 ; How much may the Bank lend? 118 ; Rate of Discount and factors governing it. Market Rate. Bank Rate in England, 118-119 ; Relation between the discount rate and the general interest rate in a country, 120 ; The Cheque System. Clearing House, 121 ; Note Issue, 122 ; Theories about Note Issue, 123-126 ; The Currency Principle and the Banking Principle, 123 ; Systems of Note Issue in different countries, 125 ; Existing arrangements as regards Note Issue, 126 ; Bank Reserves. A Bank Balance Sheet, 126 ; The objects for which bank reserves are held. The Balance Sheet of a Central Bank—the Bank Return of the Bank of England, 131 ; Gold Reserve, 131 ; Central Banks, 131- ; Functions of Central Banks, 132 ; Central Banks and Their Problems, 136 ; The Central Bank as Currency Authority, 136 ; Relation between the State and the Central Bank, 137 ; Systems of Note Issue followed by Central Banks, 138 ; The Fixed Fiduciary Reserve System, 138 ; The Proportional Reserve System, 138 ; Bank rate of the Central Bank. Open Market Operations, 140 ; International Co-operation of Central Banks, 141 ; The Bank for International Settlements, 142 ; The Banking Systems of Different Countries, 142- ; The Banking System of England, 143 ; The Bank of England, 144 ; Recent Legislation and other proposals and changes in connection with the English Monetary and Banking System, 152- ; The Currency and Bank Notes Act of 1914, 152 ; The Gold Standard Act of 1925, 152 ; The

Currency and Bank Notes Act of 1928, 152 ; The Macmillan Report, 1931, 152 ; September 20, 1931, 153 ; The Pre-War Bank Return, 156 ; The new form of the Bank Return with its improvements, 157 ; International Banking Centres. London as the pre-war World's Money Market Centre and Causes, 158 ; The Rise of New York and Paris as International Banking Centres, 159 ; The Banking System of France, 160 ; The Banking System of Germany, 161 ; The Banking System of the United States—The United States before 1913, 162 ; Defects, 162 ; The Federal Reserve Act of 1913 and after, 163 ; The Federal Reserve System—its advantages—Rediscount facilities ; Step towards centralisation of note issue ; Increased elasticity of note issue ; Increased safety against crises through the centralisation of the reserves, 164-164 ; The Banking and Monetary Systems of India, 166 ; A Central Bank for India—the proposed Reserve Bank, 166 ; The functions and advantages of the Proposed Reserve Bank, 167 ; The Gold Exchange Standard. The Proposed Gold Bullion Standard. India at present has a Sterling Exchange Standard, 169 ; The Gold Exchange Standard versus a true Gold Standard, 169 ; Arguments against a Gold Exchange Standard and in favour of a true Gold Standard, 171 ; The Gold Bullion Standard versus the Gold Standard with a Gold Currency for India, 172 ; Arguments for an Indian Gold Standard with a Gold Currency, 173 ; The Sterling Exchange Standard now in India, 174 ; Certain necessary conditions for the establishment of a true Central Bank for India (the Indian Reserve Bank), 175 ; Some criticisms of the Indian Reserve Bank (as proposed by the Government), 176 ; The Imperial Bank of India, 178 ; Constitution of the Imperial Bank, 179 ; Functions of the Imperial Bank, 179 ; The essentials of a good monetary system ; and the advantages which a country derives from such a system of money, 182 ; The essentials of a good banking system, 184 ; The value of banks—the advantages which a country derives from a good banking system, 185 ; Qualities to be possessed by good bankers, 186 ; The monetary and banking systems of a country. The World Factor, 187 ; Credit and Prices, 187-189 ; Crisis, 189-196 ; Periodicity of crises, 191 ; Causes of crises, 192 ; Ill-adjusted production—an important objective cause, 192 ; Psychological and other causes. Credit and Crisis, 192 ; Effects of a Crisis, 195 ; Beneficial results of a crisis, 195 ; Evils of a crisis and remedies, 195 ; The World Economic Depression (1929-) and the Financial crisis of 1931. Causes and effects.

Some extracts from the Macmillan Committee Report.

Summary and Questions, 196-198.

CHAPTER III.

International Trade and Foreign Exchange.

Is there a separate theory of international trade? 205 ; International values, 206 ; A paradox and its explanation, 209 ; Cost of carriage. Import and Export Duties etc., 210 ; The advantages of international trade, 210-212 ; Economic gains, 211 ; Non-economic gains (social, moral and political advantages), 212 ; Disadvantages of international trade, 212 ; Balance of trade. Balance of accounts, 214 ; The credits and debits of a country, 215 ; Imports and Exports tend to be equal, 217 ; Significance of an excess of exports, and of an excess of imports, 217 ; Foreign Exchanges, 218- ; Economising of metallic money in foreign trade, 219 ; The operation of a bill of exchange. A bill pays two debts, 219 ; Bills of Exchange, foreign bills, sight bills, long bills, etc., 221 ; The Rate of Exchange, 223 ; The Par of Exchange. Premium and Discount, 224 ; Limits to fluctuations in the rate of exchange. Specie points, 225 ; When do the rates of exchange pass beyond the specie points? 226 ; Fluctuations in the rate of exchange, 226 ; Interest rates, 227 ; Rate of exchange in relation to the total credits and debits of a country. Reparations and War Debts, 227 ; The interpretation of the foreign exchanges—favourable and unfavourable exchange, 228 ; How the exchanges automatically tend to correct themselves, 229 ; The correctives of the exchanges, 230 ; The paper exchanges, 230 ; The silver exchanges, 230 ; The Indian exchanges, 231 ; The War (1914-1918) and Foreign Exchanges, 231 ; The rate of discount and the gold reserve, 232 ; Professor Cassel's Purchasing Power Parity Theory about Foreign Exchanges, 233 ; Some criticisms of the Purchasing Power Parity Theory, 236 ; How is the Value of Money determined internationally—the natural connection between the Internal Value and the International Value of the money of a country. International banking centres—London, Paris, New York, 239 ; A good system of money should secure stability of prices and stability of international exchanges, 239 ; Britain, 241 ; The Cambridge School Arguments against the restoration of the Gold

Standard, 241 ; The London School arguments for the restoration of the Gold Standard, 242 ; Deflation and Devaluation, 243-246 ; Deflation, 243 ; Devaluation, 243 ; India and the Gold Standard, 244 ; Gold production, 244 ; The future of Gold—danger of future instability in the value of Gold. Gold is not now a stable standard of value, 245 ; Monetary Reform Proposals, 246-251 ; The tabular standard of value (multiple standard or the index-number standard), 246-247 ; Irving Fisher's compensated dollar, 248 ; The Gold Standard is the practicable ideal. National and international currency arrangements, 249 ; Protection. Free Trade, 251 ; Protection, 251 ; Free Trade, 251 ; Arguments for protection, 252 ; Economic arguments—The Home-market argument, 254 ; The employment argument or make-work argument, 255 ; The Wages argument in the United States, 255 ; The equalization of cost argument, 256 ; The argument from vested interests, 256 ; The dumping argument, 257 ; Protection as a temporary economic policy—The infant industry argument for India and other backward countries, 257 ; List's infant industry argument. Taussig and Marshall on the infant industry argument and on the diversification of industries, 258 ; Taussig, 260 ; Marshall, 261 ; Protection for agriculture in Germany, Protection for manufactures in the United States, 261 ; Non-economic arguments in favour of protection, 262 ; Diversification of industry argument, 263 ; Arguments of advocates of free trade, 265 ; Some unsatisfactory Free trade arguments, 265 ; The real case or argument for free trade. The rationale of Free Trade, 265 ; The positive advantages resulting from free trade, 266 ; Protection does not realise its aims, 266 ; Criticisms of the infant industry argument, 267 ; Protection produces certain serious evils, 267 ; Economic evils, 267 ; Non-economic evils, 269 ; India and Protection, 269 ; Dumping, retaliation, reciprocity, 272 ; Reciprocity or fair trade, 272 ; Retaliation, 273 ; Objections against a policy of retaliation, 273 ; Conclusion about Free Trade and Protection, 274 ; Certain general considerations on the subject of Free Trade and Protection, 277 ; The World War and the World Economic Depression have strengthened economic nationalism among nations, 278 ; Economic Nationalism, its evils, 278 ; The Ottawa Conference and Agreements 280 ; India and the Ottawa Agreement, 281 ; The World Factor in relation to present conditions of international trade, 284.

Summary and Questions, 284-287.

BOOK V.

Distribution.

CHAPTER I.

What is distribution? 288 ; What is distributed? The National Dividend (or National Income), 290 ; Professor Pigou on the distinction between Marshall's conception of the National Dividend and Fisher's conception, 292 ; Cannan's criticism of the National Dividend idea in distribution, 293 ; General theory of Distribution, 293 ; Distribution under imaginary and actual conditions, 195 ; Actual distribution in modern countries and the world factor, 296 ; How far is it true to say that the theory of wages is an application of the General Theory of Value, 296 ; The marginal productivity theory of distribution—some criticisms, 298.

Summary and Questions, 302-303.

CHAPTER II.

Rent.

Rent, 304 ; Rent of land, 305 ; The Ricardian theory of rent, 205 ; Criticisms and objections against the Ricardian theory, 308 ; Carey criticised and Ricardo defended, 309 ; A re-statement of the theory of rent, 310 ; Diminishing return and rent, 313 ; Rent of agricultural land, 314 ; Rent of mines, 314 ; Rent of building sites, 315 ; Different economic uses of land, 316 ; Rent and the price of agricultural produce, 317 ; When does rent enter into price? 318 ; Rent and the price of land, 318 ; Ricardian rent and actual conditions governing rent in different countries, 319 ; Quasi-rent, 320 ; Rent proper and Quasi-rent, 321 ; Rent, interest, profit, 322 ; Rent and social progress, 323 ; The unearned increment of land, 324 ; Proposals of Henry George and J. S. Mill, etc., 325 ; Objections and practical difficulties in connection with the taxation of the unearned increment, 325 ; Nationalisation of land, 326 ; Land nationalisation without compensation, 326 ; Land nationalisation with compensation, 327 ; Land Tenures, 327-335 ; Metayage or rental by shares, 328-329 ; Peasant proprietorship, 329 ; Advantages of peasant proprietorship, 330 ; Disadvantages, 330 ; India

and peasant proprietorship, 331 ; The English system of Land Tenure, 331 ; The merits of the English system, 332 ; Demerits, 332 ; Conditions of and limitations on large-scale production in agriculture, 333 ; India and large-scale agriculture, 334 ; Rent defended. Its social and economic justification, 334.

Summary and Questions, 335-337.

CHAPTER III.

Wages.

The wages question, 338 ; Wages, 338- ; Real and nominal wages, 339 ; Time wages, piece wages, efficiency earnings, 341 ; Wages and cost of labour to the employer, 341 ; Some peculiarities in connection with the demand for and supply of labour, 342 ; Is there a general rate of wages ? 343 ; Theories of wages, 343- ; Theory of the iron law of wages, 343 ; The residual claimant theory of wages, 344-345 ; The Wages Fund theory, 345-347 ; Demand and supply theory of wages, 348 ; Mobility of labour, 250 ; Dobb's theory of wages, 350 ; Taussig's theory of wages, 352 ; Criticism of Taussig's theory, 352 ; Different rates of wages in different occupations, 352 ; An evil paradox, 354 ; Low wages of women, 354 ; The conditions favouring a general high level of wages for all classes of workers in any country, 356 ; The Wage System, advantages and disadvantages, 356.

Summary and Questions, 357-359.

CHAPTER IV.

Labour Problems.

Trade Unions, 359 ; The disadvantages of labour in bargaining and how they are reduced by Trade Unions, 360 ; Two aspects of Trade Union activity—Fraternal functions ; fighting functions, 360-361 ; Trade Unions and Wages, 361 ; General wages, 361 ; The scope as well as the limitations of Trade Union action for raising wages, 362 ; Conditions under which Trade Unions may permanently raise general wages, 362 ; Wages in a particular trade, 363 ; Advantages of Trade Unions, 364 ; The Strike, 365-367 ; Syndicalism, 368 ; Labour Legisla-

tion, 369 ; Factory Acts, 369 Arguments against factory legislation, 339 ; Arguments in favour of factory legislation, 370 ; Agencies for industrial peace, 371 ; Collective bargaining, 372 ; Profit-sharing, 372 ; Advantages, 373 ; The difficulties of profit-sharing, 373 ; Gain-sharing, 374 ; The sliding scale, 374 ; Welfare arrangements, 375 ; Arbitration, 375 ; Compulsory Arbitration, 376 ; Unemployment, 377 ; Evils of unemployment, 377 ; The causes of unemployment, 377 ; Remedies, 378 ; The relief of the unemployed. Insurance, 379 ; The World Economic Depression and Unemployment, 379 ; Poverty and Poor Law, 380 ; The right to public relief, 380 ; The dangers of poor relief, 381 ; History of the English Poor Law, 382 ; The moral, 383 ; The Poor Law Commission (1905-1909), 384 ; India and Poor Law, 385 ; Labour legislation, minimum wage and social insurance, 385 ; Minimum wage, 385 ; Principle, 385 ; Advantages, 385 ; Accident, sickness, old age, unemployment, 386 ; Germany, Britain, France, United States, 387 ; Co-operation, 388 ; Consumers' Co-operation (Co-operative Stores), 388 ; Advantages, 389 ; Co-operative Credit Societies (Co-operative Banks), 389 ; Co-operative Credit Societies for agriculture. The Raiffeisen type, 392 ; Urban co-operative credit societies. The Schulze-Delitzsch type, 393 ; Co-operative production, 394.

Summary and Questions, 395-398.

CHAPTER V.

Interest.

Opinions about interest in the past and in the present, 398 ; Theories of interest, 399 ; Productivity theories, 399 ; The use theories, 400 ; Abstinence theories, 400 ; Labour theories, 400 ; Exploitation theories, 400 ; The Austrian theory of interest, 401 ; Demand and supply theory of interest, 402 ; Interest in relation to marginal productivity and marginal forbearance. Tendency of the rate of interest to a minimum, 403 ; Rent and interest, 405 ; Nett and gross interest, 405 ; Rate of interest, 405 ; Different rates of interest in different countries, 406 ; Rate of interest and the quantity of currency, 407 ; Regulation of interest, 408 ; Interest defended. Its social and economic justification, 409. प. १.

Summary and Questions, 409-410.

CHAPTER VI.

Profits.

Analysis of gross profit, 410 ; Theory of net (pure) profit, ; A zero rate of profit, 413 ; Examination of the validity of (a) 'Profits tend to an equality'. (b) 'Profits tend to a minimum', 415 ; Different theories about profit, 415 ; The theory of the English economists, 416 ; Walker's theory of profit, 416 ; Criticism of Walker's theory, 417 ; Marshall's view, 417 ; The socialistic theory of profits, 417 ; Profits per annum, and profits on the turn-over, 418 ; Does the rate of profits tend to equality, 418 ; The views of Seligman and some American economists, 418 ; Marshall's opinion, 418 ; A criticism, 419 ; Relation of wages to profits, 419.

Summary and Questions, 421-422.

BOOK VI.

CHAPTER I.

Public Finance.

Definition of public finance, 423 ; Importance of public finance, 423 ; The law of increasing public expenditure, 424 ; Divisions of public finance, 425 ; Fundamental principle of public finance, 425 ; Principles regulating public expenditure, 425 ; Classifications of public expenditure, 427 ; Productive and unproductive expenditure, 428 ; State expenditure and distribution, 429 ; Public Revenues—Classification, 429 ; Public domains, 430 ; Land nationalisation, 431 ; Public industries, 431 ; Fees and special assessments, 431 ; Taxation, 432- ; Definition of a tax, 433 ; Taxes under actual and imaginary conditions, 433 ; The State in relation to taxation of all citizens if possible, 434 ; Canons (or principles) of taxation, 434 ; Wealth and Taxable Capacity, 438 ; Theories about equity (justice) in taxation, 440 ; The benefit theory, 441 ; The equal sacrifice theory, 441 ; Edgeworth's theory of minimum sacrifice, 442 ; The faculty theory, 443 ; The general welfare theory, 445 ; Progressive and proportional taxation, 445 ; Regressive and Degressive taxation, 446 ; Arguments in favour of progressive

taxation, 446 ; Arguments against progressive taxation (and in favour of proportional taxation) ; and an examination of these arguments, 447 ; Conclusion on progressive taxation, 449 ; Why should the rich pay more in taxes than the poor ? 450 ; Direct and Indirect taxes, 450 ; Advantages of Direct taxes, 451 ; Disadvantages of Direct Taxes, 452 ; Advantages and disadvantages of Indirect Taxes, 452-453 ; Some Indirect Taxes—Custom taxes, 455 ; Defects and merits of internal revenue duties 456-467 ; Taxation of commodities, 457 ; Food taxes, 458 ; Some Direct Taxes—General property tax, 459 ; Exemptions from the income-tax, 461 ; Double taxation under the income-tax, 461 ; Merits of the Income Tax, 462 ; Disadvantages, 462 ; Inheritance Taxes and Death Duties, 463 ; Poll Taxes, 463 ; The taxation of surplus, 465 ; Taxation of unimproved land value, 465 ; Taxation of increment values, 465 ; Incidence of taxation 466 ; Incidence of different kinds of taxes, 467 ; Public Debt, 469 ; Present theory, 469 ; The different forms of public debt, 471 ; Issue of a public debt, 472 ; Loans versus taxes during a war, 473 ; Conversion of public debts, 474 ; Advantages, 474 ; Redemption of the debt, 475 ; Burden of external debt and of internal debt, 476 ; The Sinking Fund, 476 ; A Capital Levy, 476 ; Financial Administration—The National Budget, 476.

Some extracts from the Colwyn Report, 479-485.

Summary and Questions, 477-479.

CHAPTER II.

Economic Functions of Government, Socialism, etc.

The State, 485 ; State-owned and State-managed industries, 485 ; Social monopolies, 485 ; State regulation of economic activities, 487 ; State encouragement of industries, 487 ; Railways and the State, 487 ; The State and Trade, 488 ; The State and Labour, 488 ; The State and the Poor, 488. President Roosevelt of the United States on the economic functions of a modern government, 489 ; Socialism, Economic Progress, 490 ; The present distribution of wealth. Arguments against the present distribution of wealth. Arguments advanced in justification of the present system of distribution of wealth, 491-492 ; Socialism, 493 ; History of socialism—utopian socialism in the

early nineteenth century, 494 ; The proletarian and 'scientific' socialism of the latter half of the 19th century, 494 ; State socialism, 495 ; International socialism of Karl Marx, 495 ; some criticisms of Marx's theory, 496 ; The revolutionary and the evolutionary Socialists, 496 ; Character of modern socialism, 497 ; Socialistic criticism of the modern state, 498 ; Economic objections against the present system, 498 ; Moral objections against the present system, 499 ; Some elements of truth in socialism and in the socialist criticism of the Modern State, 499 ; Defects of socialism as regards (A) its criticism of the Modern State, (B) its own constructive programme, 500 ; Bertrand Russel on the Socialist State, 502 ; Some leading economists on socialism—Marshall, Seligman, Taussig, Cannan, 503 ; A defence of capitalism—Hartley Withers on "The Case for Capitalism," 505 ; J. M. Keynes and "The End of Laissez Faire," 506 ; Socialism in present politics, 509 ; Recent developments of Socialism—Sovietism, Guild Socialism, Syndicalism, 510-512 ; Co-operation, 513 ; Standard of life and standard of comfort ; Progress in relation to standards of life, 514 ; Standard of comfort in India, 514 ; Progress in the future, 515.

APPENDIX A.

War Problems and After-War Problems—War Finance, i, The cost of inflation, ii ; Inflation in relation to (a) National Distribution, (b) National Production, and (c) Government Revenue, iii ; War-Debts and Reparations, iv ; Soviet Economics and the Five-Year Plan, vii ; The World Economic Depression (1929-). The Financial Crisis (1931)—World Economic Recovery after the War, x ; The World Economic Depression, x ; Effects, xi ; The Course of the Economic Depression, xii ; The Financial Crisis, 1931-32, xiii ; The abandonment of the Gold Standard, xiii ; Causes of the World Economic Depression, Remedies, xv ; Different Causes, xvi ; War-Debts and Reparations and maldistribution and sterilisation of gold, xvii ; Cessation of foreign lending xviii ; Economic nationalism, xviii ; Rigidities in the post-war economic system, xix ; Want of international co-operation, xx ; An immediate cause, xx ; Remedies.

Calcutta University Questions (1909-1933), i-xli.

OUTLINES OF ECONOMICS

PART II.

MONEY.

Money is almost as old as mankind. Certainly it is as old as civilization itself. Literature of all times and in all countries is full of references to money, its use and abuse. In the *Iliad* of Homer, Thersites, "the uncontrolled of speech, . . . reckless in words, shrill orator" upbraids Agamemnon king of men, on various grounds and partly for greedily wanting gold as well "such as some one of the horse-taming Trojans may bring from Ilios to ransom his son." It is related of one of the great religious leaders of the world—"Jesus went into the temple of God, and cast out all them that sold and bought in the temple, and overthrew the tables of the money changers."—(*St. Matthew*, XXI. 12).

Importance of the Monetary System.

There is a close connection between the system of exchange in a country and its economic development. The monetary

The connection between the monetary system and economic progress.

system is adapted to the stage of industrial life, reached by the people, and the higher the stage of industrial life the more developed is its system of money and exchange. Economic progress is in great part the cause and in some measure at least the effect of monetary progress. This, however, has been sometimes overlooked; impulsive visionaries, indignant at the evils, springing from the immoral and wasteful use of wealth, have wanted to do away with money altogether and occasionally even economists of reputation have considerably underestimated the importance of money in relation to the economic and social life of a community.

History of Money.

In the early stages of human history there was no money to serve as a common medium of exchange, and so exchange was done by *barter* (i.e. by the direct exchange of commodity for commodity without the use of money). The inconveniences of barter led to the use of money (i.e. a common medium of exchange).

* Exchange by barter at the first stage.

† Difficulties of barter. The three serious difficulties in connection with barter are the following :—

(1) The first difficulty is the want of coincidence in barter—it is difficult to find two persons whose disposable possessions mutually suit each other's wants. If I want to get a hat

(1) Want of coincidence in barter. by barter in exchange for a superfluous coat of mine, I shall have to spend a great deal of time in trying to find a man who wants a coat and at the same time has a superfluous hat which he will barter for my coat.

(2) The second difficulty is about a measure of value. In the absence of a common medium of exchange,

(2) Want of a measure of value. at what rate is one commodity to be exchanged for another?

(3) Another inconvenience of barter results from the impossibility of dividing many kinds of goods (for example, a coat) without destroying part of the value.

Want of means of sub-division.

Many writers of text-books on Political Economy have described in detail how these inconveniences of barter led to the use of money and the system of barter was replaced by the system of exchange through money.

* The usual commonplace of text-books about a regular *barter stage* preceding the stage of money economy is challenged by a writer in the *Economic Journal* (December 1921).—"There is no known race of which it can be affirmed that they deal or have ever dealt among themselves exclusively, or even mainly, by barter."

"The whole conception of a development of economic life from a barter stage without money to the stage of money economy is doubtless essentially false.....Certainly there has never existed in the history of human life a society normally dependent upon the exchange of goods without the use of money" (Cassel—*Fundamental Thoughts in Economics*, Chapter II).

† Jevons—*Money and the Mechanism of Exchange*, Chapter I.

Prof. Hildebrand's Theory.

Indeed Prof. Hildebrand goes so far as to lay down three definite and successive stages in the history of civilization, (a) the first stage

Prof. Hildebrand's theory of monetary evolution	being characterised by the use of <i>barter</i> ;
	(b) the second stage by the use of <i>money</i> ;
	(c) and the third stage by the use of <i>credit</i> .

Recent investigations have however shown that Hildebrand's cut-and-dried theory of progress from one stage to another cannot be accepted as correct. Barter, money, as well as credit are to be found existing side by side amongst comparatively uncivilized peoples, and also among highly civilized peoples, the relative importance of the three elements being different in different times and under different conditions.

Commodity Money.

The history of commodity money is a subject of remarkable interest. In the hunting stage, skins and furs form the medium of exchange. In the next higher stage of civilization, in the pastoral stage, cattle and sometimes slaves are used as the medium of exchange. Articles of ornament, like the wampum beads among North American Indians and cowries in Asia, are also used as currency. Corn, oil, tobacco, dried fish, salt, cubes of tea, pieces of cotton cloth, even straw mats have been used as money in various times and places.

In course of time and on account of their superior convenience and other advantages, the metals specially gold and silver have replaced other commodities as money in the industrially advanced countries of the world.

(The precious metals are expensive. So we have paper money. There is a large circulation of paper money in addition to metallic money within every civilized and progressive country, paper money economising the use of the precious metals in the country).

Characteristics of good commodity Money.

It has been seen that a great many commodities have been used at one time or another as money. A commodity should possess certain qualities in order to perform its functions as money to the best advantage.

(1) The commodity should have general acceptability in order that it may be a good medium of exchange, and thus should have *value* in order that it may measure and store value.

(2) The commodity should have a steady (or stable) value. It must have this quality if it is to perform properly the functions of storing value and acting as a standard of deferred payments.

(3) The commodity to be used as money should be also durable, it should have indefinite durability. The metals, gold and silver, possess this element of durability in a greater degree than other metals like iron, etc., and much better than agricultural products and so they are more suitable for use as money.

(4) It should have large value in small bulk; if it be too bulky it would be inconvenient for use as money. Of course *the commodity to be used as money must be selected according to the needs and the economical development of the country*. Copper is a convenient medium of exchange in China with its smaller scale of payments; but in the United States with its large scale of incomes, copper would be bulky and inconvenient and gold is required as a medium of exchange.

(5) It should be easily divisible and homogeneous, and should be suitable for making payments in all sums large or small. Again it should be aggregatable, *i.e.* portions of it must be capable of being put together into a single mass without loss of value.

(6) It should be cognisable, *i.e.* it should be capable of being quickly and easily recognised. Otherwise people using it as money would be constantly running the risk of being cheated by a fraudulent substitute.

Gold and silver are very easily recognised by their colour, their sound and their weight.

(7) It should also be malleable, *i.e.* it should be suitable for coining and imprinting.

Jevons* enumerates the following qualities in the order of their importance as qualities which should be possessed by

* Jevons—*Money and the Mechanism of Exchange*.

the material of money—(1) utility and value (2) portability (3) indestructibility (4) homogeneity (5) divisibility (6) stability of value (7) cognisability.

It is obvious that the precious metals, gold and silver, combine in a larger degree than any other substance the qualities required to make a good commodity money. Gold and silver are homogeneous, divisible, cognisable and malleable, they are very durable, they have great value in small bulk and a value steadier than that of most commodities. Prof. Jevons has remarked in this connection: *"Of gold and silver, we may say with Turgot that by the nature of things they are constituted universal money independently of all convention or law."*

It is to be noted that *general acceptability and stability of value* are the two most important things in any system of money. A thing which is not generally acceptable to all persons in a country in exchange for commodities and services, cannot serve as a medium of exchange for buying and selling commodities and services in the country—it cannot serve as money. Also money without sufficient stability of value cannot do the work of money well—it cannot be good money. The yard of 36 inches is the standard measure of length and it should remain fixed at 36 inches if it is to measure lengths of cloth, wood, etc. properly—if the yard is made 33 inches one month, 38 inches next month, 37 inches the month after, if the standard of measurement varies in this way, it will upset all calculations. Money is the measure of value, it is the standard for measuring values of commodities and services, and if the standard itself varies seriously, it will upset all calculations as regards values of commodities and services and greatly disturb the economic life of the country—stability in the value of money (stability in the purchasing power of money in relation to commodities and services) is what is most important in a good system of money. Refer to the evil effects of large and rapid changes in the value of money in pages 48-49.

The increasing use of paper representatives of the monetary unit in the monetary circulation of civilized countries is

making economic science emphasize more the importance of stability in purchasing power.

*** Functions (uses) of Money. The work done by Money.**

The fundamental functions of money (the functions performed by money practically in all countries and in all times where and when money is used), are the following.

*** Definition and Functions of Money.**

There is no complete agreement as to what we mean by money.

Mr. D. H. Robertson in his *Money* uses the term money 'to denote anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligation.' According to him *money is a 'medium of exchange'*; 'but it is not necessary that everything which is a medium of exchange should itself be also a standard of value but only that it should be expressed in terms of something which is a standard of value.'

"The fundamental uses of money are to serve as a medium of exchange, and to act as a measure of value. Which of these was the earlier is uncertain as well as unimportant. As soon as the difficulties of an extensive barter disclosed themselves, the employment of a commodity for the one purpose implied its use for the other....."

Functions of Money.

The fundamental utility of money, therefore, is its acceptability or exchangeability.....Ordinary commodities have a more or less limited acceptability; money is the one thing that possesses general acceptability.

Historically almost every imaginable commodity has been used for money. Whatever happened to be common and at the same time widely wanted, served as 'money.' (Seligman—*Principles*.)

Also Mr. Robertson notices the following advantages of money :

(1) The Advantage of Money to the Consumer.

"The first great achievement of money is that it enables man as consumer to generalise his purchasing power, and to make his claims on society in the form which suits him best. If there were no money, people would have to be paid for other services in kind;.....The existence of a monetary economy helps society to discover what people want and how much they want it, and so to decide what shall be produced and in what quantities, and to make the best use of its limited productive power."

(2) The Advantage of Money to the Producer.

"The second great achievement of money is that it enables man as producer to concentrate his attention on his own job, and so add more effectively to the general flow of goods and services which constitutes the real income of society.....The existence of moneyseems to be a necessary condition for any great development of the division of labour....."

(a) Money serves as the medium of exchange for buying and selling commodities and services.

Money serving as the medium of exchange removes the inconveniences of barter and thus facilitates exchanges of all commodities and services in markets.

This is a service which is rendered by money in all economic stages.

(b) The function of money as the standard (or measure) of value.

The function of measuring value is almost inseparable from the first function, and this is also performed by money practically in all economic stages. When we say that money is a measure of value, we mean the amount of value in a unit of money may be taken as a unit of measure for calculating the value of goods ; *we reckon the values of goods in terms of money.*

Increasing emphasis upon the function of Money as a standard (or measure) of value.

In the United States, Britain, Germany and other leading countries, paper representatives of the monetary unit (bank notes, government paper money, cheques) constitute a much greater part of the circulation than the quantity of metallic money.

"The nature of the changes which the monetary system itself has been undergoing cannot be better illustrated than by the alteration in the emphasis placed by economic science upon the two functions which money is traditionally regarded as fulfilling—the function of acting as a medium of exchange and the function of acting as a standard of value, or, as it used to be put, as a common denominator of value. Victorian economic theory emphasised the first, modern theory emphasises the second, of these functions.....To an ever-increasing extent, paper representatives of the monetary unit constitute the hand-to-hand currency in circulation. The symbolic character of the monetary unit has emerged into the foreground while its relation to some actual physical material has receded."—Macmillan Committee Report on Finance and Industry, 1931, pages 10-11.

(3) The third great achievement of money is closely allied to the second. It consists in this, that money immensely facilitates the making of loans and payments in advance of all kinds."

Prof. Knapp propounds an interesting point of view in his *State Theory of Money*: "*Money is a creature of law.....The soul of the currency is not in the material of the pieces; but in the legal ordinances which regulate their use.*" Of course he is not an advocate of paper money, pure and simple. "*It is well for any State to wish to keep to specie money and to have the power to do so.*"

Kinley on the functions of Money.

Kinley thus classifies the functions of money:—

“The functions of money may be described as essential, or those which are necessary in all economic stages; as derived, or those which flow from, or are dependent on, the essential services; and as contingent, or those which flow from the conditions of a particular economic stage.

Essential Service of Money.—The essential services of money are measurement of value and facilitation of exchange.”—Kinley, *Money*, 1916, pp. 59-60.

The derived functions of money are :

(a) To serve as a standard of deferred payments.

Under the modern credit system, a considerable time often passes between the contracting of a debt and the payment of the debt. In these and other deferred payments, it is thought desirable that the borrower should return to the lender the same value which he borrowed. Money serves as a standard for these deferred payments.

(b) To transfer value.

Money transfers value from time to time as well as from place to place. It serves both for the place-transfer and the time-transfer of purchasing power.

(c) To store value.

Money serves also as a store of value. When we want to store value, it is more convenient to hoard money than any other commodity. The demand for other things may fall away, but money is always in demand. (Money serves for the place-transfer and the time-transfer of purchasing power because it is a storer of value).

The contingent functions of money in the present state of economic society are the following :

(a) The distribution of social income. (b) The equalisation of marginal utility in expenditures. (c) The furnishing of the basis of a credit system. (d) Giving a general form to capital.

(a) Under the present system of division of labour and exchange few men produce what they consume. They are paid for what they produce in money, and with this money they buy what they want to consume. Money in this way serves to distribute the wealth that is produced among the factors engaged in the work of production.

(b) Money enables each individual to spend his income in such a way that each unit of money spent shall bring him goods of the same marginal utility—thus the individual gets the largest value for the money spent by him.

(c) Another important service rendered by money is that it serves as the basis of the gigantic structure of modern credit. The modern

credit system is based upon a reserve of metallic money, and this cash reserve is used to guarantee the payment of the balances of credit transactions. Credit paper (for example, cheques) will not be accepted in payment but for the fact that there is a cash reserve to secure the payment of the cheque in metallic money when so required.

(d) Money is the embodiment of generic value, it is general capital and owing to its high mobility it is ready for use whenever any new opportunity offers and thus extends production and exercises an influence to keep it at its maximum.

Money can perform its functions properly and efficiently if the value of money (its general purchasing power) is secured from violent changes and fluctuations. Refer to pages 48-49, 52-54.

DEFINITIONS OF MONEY.

Money (a) in the narrow sense (b) and in a wide sense.

To define money is difficult because the word money in ordinary language as well as in Economics is used to indicate any one of a number of things. A

Difficulties in defining money. good deal of controversy has taken place as to the proper definition of the term "money"; and this controversy has been largely due to the fact that different writers have referred to different things by the same word money. The difficulties of definition disappear as soon as we decide in what sense the word money is properly used.

A writer's definition of money depends upon the view held by him as to the nature of money, and to the services rendered by it.

Some of the different views held as to the meaning of the word money are given below :

(1) Money is sometimes used to mean commodity money. According to this view only metallic money is money because it has a value based on its direct use for consumption; it has an intrinsic value due to demand for it for other

The word money used in a narrow sense.

than monetary purposes. Paper money is not money because paper has very little intrinsic value.

This view is not correct. Common usage is against using the word money to mean only metallic money and not paper money. Paper money is also money, it performs money functions and it has value if there is a demand for it as money.

(2) The word money is sometimes used also to mean money instruments (*metallic money and paper money*) issued by the government—bank notes and other things being thus excluded from the category of money.

The word money is used in another narrow sense.

This meaning of the word money (as it excludes bank notes) is also too narrow and is against common usage and the general practice of economic writers.

(3) Money is also used to describe (a) money made of gold and silver and paper money (e.g. bank notes and notes issued by the government) which are generally acceptable as money and (b) also bills of exchange and cheques which are not generally acceptable. Cheques and bills of exchange are not generally acceptable as a medium of exchange, as they cannot be accepted from persons little known and of little credit—they do not perform the essential money function and so are not money in the usual sense.

(4) *The term money should be properly applied to all media of exchange (viz. metallic money, paper money or notes issued by the government and by reliable banks) which are generally acceptable, which pass freely from hand to hand as media of exchange even among strangers within a country. These media of exchange perform properly the essential money function of a general medium of exchange, they do the money work and so they are money in the proper sense of the term.*

In India, money in this sense would include (a) metallic money, gold and silver and (b) the paper money or notes issued by the Government. In the United States, money includes the

metallic and paper money issued by the Government and notes issued by banks. Metallic money, notes issued by a Government or by a solidly established bank are instruments of general acceptability, they are readily accepted by all persons in payment from all persons, known parties as well as strangers ; so they are money.

When the paper money of an unsound bank or of an insolvent government ceases to be generally accepted by the people it ceases to be money in the proper sense of the word.

Some definitions of Money.

(1) † Ely's definition of Money.

Money is anything that passes freely from hand to hand, as a medium of exchange, and is *generally* received in final discharge of debts.

(2) Kinley's definition.

"We may limit the term money to that part of the medium of exchange which passes *generally* current in exchange and settlement of debts, without making the discharge of obligations contingent on the action of a third party or on the action of the payer by promising redemption if the money article does not pass."

(3) Robertson's definition.

"There is no very general agreement upon this point ; but as with so many other economic terms, it does not matter very much what meaning we adopt as long as we stick to it, or at any rate do not change it without being aware that we are doing so. In this book, the term money will be used to denote anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligation."

(4) Money may be defined as that which does the money work of serving as the medium of exchange being generally

* Elementary Principles by Ely and Wicker.

accepted in payment for goods and services. National money serves as a medium of exchange within a particular country ; international money serves as a medium of exchange between nations.

It will be seen that in each of these definitions, serving as the medium of exchange is regarded as the fundamental function of money.

A simple and adequate definition is this: The money of a country refers to that which is widely used to buy commodities and services and measure their values.

COINAGE AND CURRENCY.

Coinage.

The manufacture of metallic money is called coinage. Coins are stamped and certified pieces of metal ; and the object of a good system of coinage is to secure uniformity in coins of the same kind, convenience of shape, size and weight and to prevent counterfeiting

In all advanced modern countries, coinage is a function exercised by the government, an authority in which every one has confidence.

The charge for coinage.

A country is said to have a system of free coinage of a metal when every private citizen having bullion is allowed to bring it to the mint and to have it converted into coin.

On the other hand, a country is said to have limited coinage when coinage is done only on government account, and when the private citizen is not allowed to bring bullion into the mint and to have it converted into coins. There is no free coinage of the rupee in India, it is subject to limited coinage. In pre-war England, the sovereign is subject to free coinage.

A system of free coinage does not necessarily imply in all cases that no charge is made by the government for coinage. Under the system of free coinage we may have

(a) gratuitous coinage when no fee is charged by the government for the work of coinage ;

(b) coinage on payment of brassage.

The fee charged by the government for coinage is called brassage when it is exactly equal to the cost of coinage.

If a fee larger than the cost of coinage is charged by the government, the fee is called seigniorage. (The expression seigniorage is also sometimes used to include brassage).

The rate at which gold coin is given by the mint in exchange for gold bullion is called the mint-price of gold. In pre-war England, the mint-price of standard gold is £3 17s. 10½d. per ounce, i.e., each ounce of gold is manufactured into sovereigns at this rate.

The Currency.

The medium of exchange in a country includes (a) the medium of general circulation or the currency (or money) including (1) metallic money, (2) inconvertible paper money, (3) convertible notes.

(b) the medium of restricted circulation including credit paper which does not circulate generally, e.g. cheques and drafts representing bank deposits and bills of exchange representing goods.

*** The Kinds of Money—Standard Money. Token Money. Credit Money. Legal Tender Money. Common Money and Bank Money.**

The currency of a country includes Standard Money, Token Money and Credit Money.

* Different kinds of Money.

Economists differ in their classification of money.

Mr. Robertson notices the following classes and sub-classes :

Bank Money and Common Money : Legal Tender, Optional and Subsidiary Money ; Convertible and Standard Money ; Token and Full-bodied Money.

Prof. Seligman gives the following classification :

"Money may be classified in three ways—as actual and ideal money, as metallic and paper money, as standard and token money.

(1) Actual money is that which actually circulates. Ideal money or money of account is that in which accounts are kept.....

is that money which measures the values of commodities and services in the country and to the value of which the values of all other kinds of money are adjusted. The standard coin is one of which the value in exchange depends on the value of the metal contained in the standard coin.

Token Money is money which is used as small change generally in transactions of comparatively small value. Token money is generally made of a baser metal than the standard money; and the value of a token coin is higher by law than the value of the metal contained in the token coin.

In England the shilling is a token coin. As a coin, the shilling is worth $\frac{1}{20}$ th of a pound, (20 shillings are equal to £1); but the value of the silver contained in the shilling is worth much less than $\frac{1}{20}$ th of a pound. The penny is also a token coin.

In India the rupee is worth more as coin than what it is worth as metal when it is melted. And so the rupee is also token coin; other token coins in India are the two-anna bit, the four-anna bit, the nickel anna and the pice.

Credit money or paper money is issued on the credit of the government or on the credit of a bank and it is readily accepted by the people if the people have confidence in the credit of the institution issuing the money.

One important thing to remember is that other forms of money (token money, credit money) are exchangeable directly or indirectly into standard money.

The currency of a country includes Legal Tender Money and money that is not legal tender. Legal tender money is money which a creditor is obliged by law to receive in repayment of a debt due to him.

(2) Paper money as opposed to metallic money may be subdivided into three classes—representative, fiat, and fiduciary money. Representative money consists of paper which certifies that an equivalent amount of coin or bullion is deposited in the government treasury, like the American gold and silver certificates. Fiat money consists of paper whose value rests on the fiat or declaration of the government, like the American greenbacks. Fiduciary or credit money consists of promises issued by private or semi-private institutions to pay coin, like the national bank notes.....

Generally the standard money is made unlimited legal tender, i.e. it is made legal tender up to an unlimited amount. The sovereign is unlimited legal tender in pre-war England. Token money is generally made limited legal tender, i.e., legal tender up to a limited amount. In England the shilling, a token coin, is legal tender only up to forty shillings. In India the rupee, though a token coin, is unlimited legal tender. In India, the sovereign and the half-sovereign are unlimited legal tender, and so the rupee and the half-rupee; the subsidiary coins of silver, nickel etc. are legal tender up to a limit of Re. 1 only.

The standard money is (a) *subject to free coinage* (b) being subject to free coinage has its nominal value or *coin value equal to its intrinsic value as metal* (c) and is *unlimited legal tender*.

Token money is (a) *not subject to free coinage* but is subject to limited coinage at the discretion of the government and (b) it has a face value or *coin value greater than its intrinsic value as metal*, and (c) is very generally *limited legal tender* and may be regarded as *subsidiary money*.

[A distinction is sometimes made between (a) common money or money which is universally acceptable within a given political area (or country), and (b) bank money which requires special knowledge and the making of special arrangements on the part of the recipient.

Metallic Money as Standard Money. Paper Money as Standard Money.

The standard money of a country is that money which measures the values of commodities in the country and to the value of which the values of other kinds of money in the country are adjusted. The standard money is very usually unlimited legal tender. (A country may have standard money of gold only. Another country may have standard money of gold and also standard money of silver—this is Bimetallism or the Double Standard.) Britain, United States and many other countries to-day have not a gold standard but a paper standard—the standard money being paper money inconvertible

into gold. In Britain the standard money now is the paper pound (the note)—the pound sterling—and Britain is said to have a sterling standard.

Some important monetary questions.

Three most important topics in the study of Money—in “the still-vex’d Bermoothes”^{*} of monetary controversy—are the following :

I. The Value of Money—how to measure changes in Value of Money by Index Numbers.

II. The causes which bring about changes in the Value of Money.

III. The effects of changes in the Value of Money.

I. Measurement of changes in the value of money—Index Numbers.

(The changes in the purchasing power of money are measured by Index Numbers of prices.)

At first sight it might seem impossible that changes in prices can be measured, because the prices of different commodities are sometimes moving in different directions. This difficulty however can be overcome by *averaging*—if the price of one commodity rises 30 per cent. and if the price of another commodity falls 30 per cent. we may say that on an average, the prices of the commodities have neither fallen nor risen. We may take the prices of many commodities and averaging them find an average price for some standard year; and by comparing the average price in another year with the average price of the standard year, we may measure changes in average price of commodities, and from that we may calculate changes in the value of money.

(If the average price of commodities has fallen, obviously the value (the purchasing power) of money has risen; and if the average price has risen, the value of money has fallen.)

Relation between the value of money and prices (i.e. the price level of commodities).

When 40 seers of rice are sold for Rs. 4, then the purchasing power of a rupee equals ten seers of rice. When the price of the commodity has fallen from Rs. 4 a maund to Rs. 3 a maund, the purchasing power of money (of the rupee) has risen from 10 seers to $13\frac{1}{3}$ seers.

^{*} Shakespeare, *The Tempest*, I. ii.

To put it in more general form a fall in the price level (i.e. general prices of commodities) means an increased purchasing power of money and a rise in general prices means diminished purchasing power of money. The reciprocal relation between changes in the purchasing power of money and changes in the level of prices should be carefully remembered

Purposes for which Index Numbers are used—

the services rendered by index numbers.

(1) To find for the student of economic history a rough measure of changes in welfare from time to time, as shown by changes in the purchasing power of money.

(2) To supply means for measuring the purchasing power of wages and other incomes in the same country at different periods and also in different places and among different peoples

(3) To furnish a basis for the equitable discharge of long-term debts.

(4) To furnish a standard to keep general prices steady in order to keep trade stable. This is much advocated now-a-days by eminent economists like Irving Fisher, Gustav Cassel, J. M. Keynes and others.

How to construct a table of Index Numbers—general rules.*

The chief points in the construction of a table of index numbers are the following

(1) The selection of a standard or basic period

(2) The selection of commodities

(3) The collection of price quotations of the selected commodities at different periods, and the calculations of the ratios of these prices to the prices of these commodities in the base period

(4) Average of the price ratios

(1) Basic Period

First, we take up the question of the basic period

One period is to be selected as the standard or basic period and the prices of other periods are to be compared with the prices of the standard period (The standard period may be selected as one particular year, e.g., Jevons took the year 1871 as the standard period, but some economists select a longer period, a series of more or less normal years as the basic period for index numbers)

(2) Selection of commodities

* According to Prof. Marshall, the best base for any year seems to be the previous year.

† The number of commodities selected varies. The well-known 'Economist' index number is based on 22 commodities; that of Sauerbeck on 45 commodities. Falkner takes a large number and includes 223 commodities in all (Fisher—*The Purchasing Power of Money*, Chapter X)

Another difficulty lies in the proper selection of commodities of which prices are to be taken. The list of commodities must be as representative as possible.

It must include important food grains, raw materials, manufactured commodities, the principal articles of production and consumption and trade in the country. (In the various sets of *general* index numbers prepared by different writers and Governments, the number of commodities taken varies ~~but~~ but it is never less than twenty).

(While constructing index numbers for *special* purposes, we must, in selecting commodities, pay attention to the special purpose in view. For example while calculating changes in the purchasing power of the income of the working class we must select those commodities which bulk largely in the family budget of the working man).

(3) *Collection of prices*, and calculation of price ratios..

A third difficulty lies in the proper collection of prices and calculation of price ratios.

In the collection of price quotations, care must be taken that the prices, quoted for the same commodity, in succeeding years are for the same quality of the commodity.

We should take wholesale or retail prices according to the particular purposes in view. Wholesale prices are more accurately known, apply to a larger area and are generally more convenient for general purposes. For the purposes of showing the change in the cost of living of any particular class of people retail prices must be used.

When the prices of the representative commodities in different periods have been collected these prices must be expressed as ratios of the prices of the same commodities in the standard period.

(4) *Average—question of weighting.*

The averaging of the prices of the commodities in each period can be done in many ways.

The simple arithmetical average (with a large number of representative commodities) yields practically as good results as index numbers obtained by other kinds of averages (weighted and unweighted).

It is best therefore to use the simple arithmetical average; and this is found for any particular period by summing the relative prices of the commodities and then dividing by the number of commodities.

The average price may be calculated in the following different ways :

(1) The *arithmetical average* may be taken. Sometimes the average price in a particular period is calculated by taking (2) the *geometrical average*, the n th root of the product of the relative prices of commodities. Other kinds of averages are (3) the *median* which divides the relative prices of one particular year into two halves, half of the relative prices being above the median and the other relative prices being below it and (4) the *mode*.

Again when calculating the average price for any year, the same importance may not be attached to all the commodities. A commodity

which is more important in the consumption or in the trade of the country will not have the number 100 assigned to it but a higher number, the exact amount of weight to be given to each commodity depending upon its relative importance for the particular purpose in view. This sort of average is called the weighted average.

Weighted index numbers seem to be theoretically preferable; but numerous experiments have shown that different systems of weighted index numbers and a system of unweighted numbers (with a large number of representative commodities) yield almost the same results.

A typical table of Index Numbers.

The actual formation of index numbers of prices is shown in the following table. The table is formed by following the general rules already discussed relating to the construction of index numbers; and for the purpose of simplifying the thing only six commodities have been taken, a number which would be quite inadequate in actual practice.

	1890	1900	1910
	Rs. as.	Rs. as.	Rs. as.
Rice per bushel ...	... 3 0 100	2 0 66⅔	2 8 83⅓
Wheat per bushel ...	... 2 0 100	2 8 125	2 12 137⅓
Steel per ton ...	... 60 0 100	50 0 83⅓	40 0 66⅓
Sugar per pound ...	... 0 8 100	0 12 150	0 10 125
Coal per ton ...	... 8 0 100	7 0 87½	8 8 106⅓
Tea per lb. ...	... 1 0 100	1 4 125	1 2 112½
Average price	600+6=100	617½+6=106⅓	611⅓+6=105⅓

(1) In the above table the year 1890 is taken as the standard year. The prices of commodities in other years are compared with the prices of the same commodities in the standard year.

(2) Six commodities, viz. rice, wheat, steel, sugar, coal, tea have been selected as representative commodities.

(3) The prices of the representative commodities in the standard year and in other years have been put down in the table. The price of each commodity in 1900 and 1910 has been expressed as a percentage of the price of the same commodity in the standard year 1890.

The price of rice in 1890 is Rs. 3 and if the price of rice in 1890 be represented by 100, the price of rice in the year 1900 (Rs. 2) will be represented by the figure 66⅔. Prices of the other commodities in other years are similarly expressed as percentages of the prices of those commodities in the standard year.

(4) The simple arithmetical average of the relative prices of commodities each year has been used to form the average price of each

year,—the average price in 1890 is 100, the average price in 1900 is 106½ and in 1910 it is 105½. The average price of each year is called the Index Number of that year.

In the above table of index numbers there has been no weighting of any particular commodity.

Index Numbers for Calcutta Prices.

Suppose we are asked to construct a table of index numbers for prices in Calcutta for 15 years from 1899 to 1913 (C. II, 1924).

(1) Then the year 1899 is to be taken as *the standard year*. That year was however a famine year, and not a normal one; and so it would be better to take, as the basic period, the whole period from 1890 to 1899 which may be taken as a normal period, free from abnormal fluctuations.

(2) Calcutta is a port where modern economic conditions are more pronounced than in the rural parts of India and where the number of articles, for which price quotations are available, is much larger than in the interior tracts.

The representative commodities in Calcutta are rice, wheat, dal, milk, ghee, mustard oil, potato, sugar, salt, tobacco as articles of general consumption and articles of foreign trade like jute, cotton, hides, oilseeds, tea, coal, and iron, etc. It should be noticed that prices in Calcutta are related on the one hand to prices in the interior tracts of India and on the other hand to prices in world markets.

(3) The arithmetical average of these prices will yield practically the same results as any other system of averaging; and so the arithmetical average may be taken.

Limitations of Index Numbers. Practical and other difficulties relating to the construction of Index Numbers.

How far do index numbers satisfactorily measure changes in the purchasing power of money?

The value of index numbers for the purpose of satisfactorily measuring changes in the purchasing power of money depends upon the following conditions :

(1) Whether the commodities included in the table are representative and are properly selected for the particular purpose in view.

(2) Whether the prices of the commodities are known to a sufficient degree of accuracy.

(3) Whether the standard or basic period is judiciously selected.

(4) Whether the averaging of price ratios, and weighting (when it is necessary) are done with discrimination and judgment.

Index numbers of prices of commodities may be used to measure changes in the purchasing power of money as regards the income of the working class or any other class in a country. But there are practical difficulties in the way. Wage-earners purchase commodities.

for their consumption retail, and so such index numbers will require retail prices and accurate retail prices are difficult to get. Index numbers based on inaccurate retail prices will not measure satisfactorily changes in the purchasing power of money used for consumption by the working class or some other class.

The practical difficulties may be overcome by better arrangements for getting substantially accurate retail prices in modern countries. But there are more fundamental difficulties. They must be seriously considered.

Index numbers are to measure changes in the value of money. We must make sure in the beginning that these changes in the value of money are to be measured for what purpose. *The selection of commodities will depend upon the particular purpose in view.*

If the index numbers are intended to measure changes in the value of money in the most general sense for a particular country, then the selected commodities must include important articles of consumption, and also all other things exchanged including land, houses, securities, also the cost of such services as railway carriage or education.

Again if we want to construct index numbers for measuring changes in the cost of living of families in a country, we must have a definite idea as to changes in whose cost of living we are going to measure. The cost of living of an Indian labourer in a jute mill includes certain commodities; the cost of living of an Indian doctor or lawyer of moderate practice does not include exactly the same commodities as are consumed by the average Indian labourer. So for the construction of index numbers for measuring changes in the value of money to different classes of persons in a country as regards their cost of living, the selection of commodities must be different in different cases. Index numbers based upon commodities used by the average Indian labourer may show a fall in the value of money (the money income of the labourer) by 25 p.c., indicating a rise in the cost of living as regards the labourer's family; but the change in the cost of living as regards the family of the doctor or lawyer may be different depending on somewhat different commodities. The doctor or the lawyer will require more education, better qualities of food and clothing, more comforts and luxuries generally for the members of his family than the labourer.

The right selections of commodities for constructing index numbers for such different purposes have their serious difficulties which cannot be always overcome.

Suppose we select the commodities consumed by an average labourer in a particular year. We form an index number based upon these commodities and take the particular year as the standard year. We consider the index numbers of these commodities based upon their prices twenty years after. We find that the index number has risen from 100 in the standard year to 150 twenty years after. Apparently the cost of living of the labourer has been increased by 50 p.c. In reality it may be much less. For the labourer may be using not the

same commodities as he was using 20 years ago; he may be using some cheaper substitutes, and as regards other commodities he may be using more of those commodities which have fallen or not greatly risen in price, and he may be using less of those commodities which have greatly risen in price. This brings to light the danger of depending too much upon index numbers as indicating exactly changes in the value of money to any particular class of people.

Index numbers are thus useful as an instrument for roughly measuring changes in the value of money—but not exactly and accurately.

"The conclusion then is that neither in practice nor perhaps even in theory is it possible to measure accurately changes in the value of money. Nevertheless there is no doubt that the value of money does change, and, if sufficient care is taken, measures accurate enough for some practical purposes can be found and used"—Robertson, *Money*, 1930, p. 27.

As Marshall has stated: "a perfectly exact measure of purchasing power is not only unattainable but even unthinkable."

II. HOW THE VALUE OF MONEY IS DETERMINED.

The causes which bring about changes in the value of money—how the value of money is determined.

* Theory about the value of Money.

A difficult and most important topic in the theory of money is the determination of its value.

I. The Demand and Supply Theory about the value of Money.

The value of wheat (or iron or cotton etc.) refers to its

* Value of Money.

"The value of money is its purchasing power, and can be learned only from the general level of prices. Prices of single commodities may rise or fall because of relative variations in the forces which affect particular demand and supply. But there can be no change in the prices of *all* commodities unless there is a corresponding change in the value of money." (Seligman—*Principles*.)

"By the value of money we mean something exactly analogous to what we mean by the value of anything else, say bread or cloth: that is to say, we mean the amount of things in general which will be given in exchange for a unit of money." (Robertson—*Money*.)

value in exchange—its purchasing power, its power to purchase other commodities in exchange for it.

(The value of money means the same thing—its purchasing power, its power to purchase other commodities in exchange for it.)

The value of money (the value of the monetary unit), its purchasing power, is not constant. Sometimes it rises. Sometimes it falls.) (In India the monetary unit is the rupee, in England the monetary unit is the pound sterling. The monetary unit in circulation may be metallic money or paper money or both). *(The value of the monetary unit (the rupee or any other monetary unit) rises when prices of commodities in general are falling—the monetary unit is then able to purchase more of commodities than before. The value of the monetary unit is falling when prices of commodities in general are rising—money is then able to purchase less commodities than before.)* The value of money in India now is much less than it was 100 years ago for the rupee now purchases much less in commodities (i.e. smaller quantities of rice, wheat and other commodities) than the rupee could purchase 100 years ago.

Why does the value of money in a country rise? Why does it fall? What are the causes determining the value of money (the value of the monetary unit)?

Let us imagine a simple case. Suppose in a country the quantity of commodities and services produced has not changed practically. But every one has now more money—many persons much more money—than before. Then persons will be offering more money and using more money than before to buy the same quantity of commodities and services. The prices of commodities (and services) will rise. The value of the monetary unit will fall. Or suppose every one has less money than before. Then prices of commodities in general will fall and the value of money will rise. Changes in the value of money are thus brought about by changes in quantity of money and also by changes in the demand for money when there is such change in demand.

Now the value of money is (like the value of everything else) a question of demand and supply.

(The supply of money depends upon the cost of producing the money and upon any other cause limiting supply. The

total supply of money) or the money force available to do the exchanging work of the community (is composed of two factors: (1) the amount of money and (2) the rapidity of circulation. (If one coin performs five exchanges on an average in a week, and another kind of coin performs ten exchanges—the second coin has double the rapidity of circulation of the first coin))

(In a backward country money may mean metallic money chiefly or exclusively; in advanced modern countries money includes metallic money, also paper money in increasing quantities).

(The demand for money in a community depends upon the amount of exchanging work to be done by money.) All wealth that is produced is not exchanged through the medium of money. Part

Demand for money. of the wealth produced is directly consumed by the producers; part of it is exchanged by barter; and only a part (in a modern society the greater part) is exchanged through the medium of money—and this constitutes the monetary demand in a community.

The value of money varies *inversely* as its supply and ~~directly as its demand~~, other things being equal.

Determination of (a) the Value of Money and (b) the Value of other Commodities. Similarity and Difference.

Similarity

Money is a commodity; and money resembles other commodities in this that its value is fundamentally determined by the conditions of demand for it in relation to the quantity (and supply) of it.

Difference.

Also money has its differences from most other things; and because of the differences, the theory about the value of money has its peculiarities differentiating it from the theory about the value of most other things.

There is an essential difference between the demand for money and the demand for most other things.

* *Money is different from most other commodities as regards its demand—under given conditions the demand for money (this demand consists of all commodities to be exchanged for money in the country) is constant, and the elasticity of demand for money is unity, but this is not the case as regards most other commodities. In this money is unique.* This difference depends upon the nature and use of money (as a medium of exchange) as different from the nature and use of consumable commodities used for satisfying wants directly.

* Let us try to understand what certain economists mean by statements of the nature made above.

Let us consider the demand for milk and mangoes—and also the demand for money.

There is a demand for milk, because milk satisfies human want directly, it gives direct enjoyment to the consumer. This is the case also with mangoes and other consumable commodities.

As regards milk, with increase in supply and fall in price, the demand increases—the demand is not constant. The same is the case with mangoes and most other consumable commodities (except necessities in a country so rich that with existing prices all persons are able to buy as much of necessities as they require and so with increased supply and fall in the price of necessities, men do not buy more). (1) It has been stated before on page Vol. I, that if with increased supply and fall in price as regards a commodity, if the demand increases *proportionately* so that *the total sum of money paid by buyers in the market remains unchanged, then the elasticity of demand for the commodity is said to be unity*. So with a rise in price, if demand for the commodity falls proportionately so that the total sum of money paid remains unaltered, the elasticity of demand for the commodity is regarded as unity. (2) If with fall in price the increase in demand is more than proportionate and with rise in price, the decrease in demand is less than proportionate, so that with change in the price of the thing the total sum of money paid by buyers in the market increases, the elasticity of demand for the commodity in the market is said to be greater than unity. (3) If with change in the supply and the price of the thing, the total sum of money paid decreases, the elasticity of demand for the commodity is said to be less than unity. *As regards most consumable things in the market, actual observations show that elasticity of demand is not unity, is either greater than unity or less than unity; and if as regards a few commodities it is equal to unity—“the elasticity of demand for cotton or apples may happen to be unity”* (Taussig, *Principles of Economics*, Vol. I., 1925, page 234)—it is more or less an accident and not due to the very nature and use of the thing.

It will be explained presently that under given conditions, the demand for money is constant and the elasticity of demand for money is unity; and in this money is unique and differs from most other things,

II. The Quantity Theory about the Value of Money.

(Under the given conditions, the demand for money being constant, the value of money varies with changes in supply, the value of money varies exactly in inverse relation to changes in the quantity of money—the value of money is halved if the quantity of money is doubled, the value of money is reduced

Milk or mangoe is demanded, because it satisfies human want directly and gives direct satisfaction to the consumer. Money is different. Money does not satisfy human wants directly, we do not eat bodily coins or bank notes—money serves only as a medium of exchange for buying commodities and services. This is the fundamental nature and use of money—and because of this fundamental nature and use of money, it can be shown that the demand for money is constant and elasticity of demand for money is unity. At any time in any given country the demand for money comes from the commodities and services to be exchanged by using money as the medium of exchange; and taking a very short period of time the quantity of commodities and services in the country to be exchanged for money does not change and ~~so the demand for money coming from its use as a medium of exchange and depending upon this quantity of commodities and services does not change.~~ [In a longer period of time (a) with growth of population and improvements in the methods of production the quantity of commodities and services produced may increase and may thus increase the demand for money; (b) with declining population, etc., the quantity of commodities and services produced may decrease bringing about decrease in the demand for money.] In a comparatively short period of time, population does not change practically, nor methods of production, and so the quantity of goods and services produced does not change and so the demand for money does not change. Under these given conditions the demand for money is constant—the demand for money and the quantity of goods and services produced do not change even though there be increase or decrease in the supply of money bringing about fall or rise in its value.

It thus appears that under given conditions (taking a very short period of time with population and methods of production, etc., practically unchanged) the demand for money is constant, because of the fundamental nature and use of money as a medium of exchange. The elasticity of demand for money is unity in this sense that under these given conditions the total quantity of commodity and services to be exchanged for money remains unchanged, whether there is increase or decrease in the supply of money with decrease or increase in its value. (We have seen that the elasticity of demand for a consumable commodity like apples is said to be unity when the total quantity of money paid by buyers remains unchanged with change in the supply and value of apples. A consumable commodity is exchanged for money. But money is exchanged for commodities; and so under given conditions the elasticity of demand for money is said to be unity as the total quantity of commodities and services to be exchanged for money remains unchanged).

to one-sixth, if the quantity of money is increased six-fold
This is the Quantity Theory about the value of money.

The Quantity Theory is thus largely based upon a peculiarity as regards the demand for money—under given conditions, the demand for money is constant and the elasticity of demand for money is unity.

As regards milk or mango the demand is not constant and elasticity of demand is not equal to unity. So with a two-fold increase in the supply of milk, the value of milk is not reduced exactly to half, with four-fold increase, the value is not reduced exactly to one-fourth. The change in the value of milk is not exactly in inverse relation to change in supply as the change in value depends upon supply and also upon elasticity of demand as regards milk.

Theoretical Proof of the Quantity Theory.

(The truth of the quantity theory about the value of money is easily derived from the demand and supply theory about the value of money.)

It has been already stated that (the value of money, like the value of any other commodity, is fundamentally determined by the conditions of demand in relation to the quantity) (and supply) of it available. This is the Demand and Supply Theory about the value of money.

Under given conditions (or other things being equal, i.e., with the demand for money constant and other factors like rapidity of circulation of money unchanged), the value of money varies exactly in inverse relation to changes in quantity—this Quantity Theory about the value of money states the Demand and Supply Theory about the value of money under the conditions when demand for money is unchanged and rapidity of circulation of money is unchanged. So the Quantity Theory is a particular case of the Demand and Supply Theory and its truth is derived from the truth of the Demand and Supply Theory.

Also the Quantity Theory, as stated in the above italicised words, making the value of money depend upon the change in quantity of it, and making no explicit mention of demand (and other factors, like rapidity of circulation of money as regards

supply), is thus a shorter way* of stating the Demand and Supply Theory about the value of money.

† The Quantity Theory about the Value of Money.

(The quantity theory states the relation between the value of money and its quantity—if the demand for money remains unaltered, the value of money depends on its supply and varies exactly in inverse proportion to its supply (the total number of units of money available). When the quantity of money increases, the value of money falls as compared with commodities and the prices of commodities rise) as more units of money are available to purchase each unit of commodity (and when the quantity of money decreases in a country, the value of money rises as compared with commodities and the prices of commodities fall as fewer units of money are available for purchasing each unit of commodity.)

round about

*'The quantity theory is only an elliptical way of stating the ordinary laws of demand and supply'. Explain this statement. (C. U. 1933.)

(While the quantity theory of money is therefore untenable in its crude form, it may nevertheless be employed to mean that, in the absence of relative changes in the other factors, a variation in the quantity of money will produce a change in the price level. In this sense the "quantity theory" is only an elliptical way of stating the ordinary law of demand and supply.) There is an additional defence for the "quantity theory" in this sense, because when we come to examine the really controlling factors over long periods of time, we find that the emphasis can well be laid on the supply side, and especially on the quantity of money." (Seligman—Principles.)

† The Quantity Theory—(a) its crude, bald form, (b) its scientific and developed form.

"It is obvious.... that the famous "quantity theory" of money—the theory that the (value of money depends on its quantity)—is indefensible in the bald form. [For the value of anything does not depend, as we know, upon the supply alone nor upon the demand alone, but is a result of the equilibrium between supply and demand. So that in the law of money given above, the level of prices may be affected not only by changes in the rapidity of circulation as well as in the quantity of money, but also by changes in the volume of transactions].....

The more comprehensive law of money, then, may be summed up in the equation: the supply of money (less the sums used as a reserve and a share of value) multiplied by the rapidity of circulation is equal to the volume of exchanges in a given period as modified by the credit transactions entered at a given price-level.

(J. M. Keynes notes in his *Tract on Monetary Reform* that the common assumption that the elasticity of demand for money is unity does not hold in extreme cases).

(1) The theory in its simple unqualified form is true only in a simple and primitive state of things.

(The quantity theory in its simple form states that the value of money falls proportionately (and the price level of commodities rises) with an increase in the quantity of money and that the value of money rises proportionately (and the price level of commodities falls) with a decrease in the quantity of money.)

Mill remarks 'that an increase in the quantity of money raises prices and a diminution lowers them (i.e. prices of commodities) is the most elementary proposition in the theory of currency'; but he is careful to point out that this unqualified statement of the quantity theory is true only in a simple and primitive state of things. By a simple and primitive state of things a somewhat imaginary type of society is perhaps referred to where there is no credit, metallic money (gold and silver) is the exclusive instrument of exchange, there is no hoarding and no barter, and all commodities are for exchange, that the volume of business does not change and there is no change in the habits of people as regards the use of money. *Only in such a simple primitive state of society*, we have that direct and intimate connection between quantity of money and prices which is asserted in the unqualified form of the quantity theory.

In the actual complex conditions of modern countries, where credit is used as means of purchasing power and where we have to take note of other factors, like hoarding, barter, etc., the connection between prices and the quantity of metallic money is not so direct as is stated in Mill's elementary proposition; and so to such societies the quantity theory in its simple unqualified form does not apply.

(2) A more * 'scientific' and developed form of the quantity theory (stated with proper qualifications to suit modern conditions and as accepted by several modern economists).

The quantity theory must be rightly stated with suitable limitations to make it applicable to modern industrial countries with a developed credit system and with changing industrial and monetary conditions. And in a properly qualified form, the truth of the theory is admitted practically by all modern economists.

The truth of the Quantity Theory of Money follows from the Demand and Supply Theory about the Value of Money. Refer to the Theoretical Proof of the Quantity Theory on page 27.

Also the Quantity Theory is supported by abundant historical evidence. Refer to pages 39-41.

It has to be remembered that when applying the quantity theory to advanced modern countries (pre-war and post-war) like the United States, Great Britain, Germany, we are using "money" to mean total purchasing power in terms of money—

*** Short and long periods.**

(1) Fisher.

The Quantity Theory in its scientific form will not hold true strictly and absolutely during transition periods. A sudden change in the quantity of money and deposits will temporarily in transition periods affect their velocities of circulation and the volume of trade; and change in the quantity of money in such a period may not produce proportional change in prices.

Normally (i.e., in the long run when the transition periods are completed) changes in the quantity of money produce proportional changes in prices (i.e., in the general price level). Fisher has proved that under such conditions a change in the quantity of money does not affect velocities or the volume of trade and so far as the quantity of money does not affect velocities or the volume of trade and so far as the quantity of money is concerned its effect on prices is strictly proportional—variations in money supply produce proportional changes in prices.

(a) Taussig.

For short periods, even for many years, it is often difficult to trace any connection between the quantity of specie and prices.

On the other hand, in the long run, a relation between the volume of specie and prices is to be discerned, while the precise quantitative relation between prices and the total purchasing power in terms of money remains unshaken."—Principles.

and in these countries* general purchasing power in terms of money includes specie, government paper money, bank notes, deposits and cheques.

We may state the **Quantity Theory about the Value of Money** thus—*other things being equal, the value of money falls proportionately (and the price level rises) with increase in the quantity of money and the value of money rises proportionately (and the price level falls) with a diminution in the quantity of money.*

The quantity theory is thus true under certain hypothetical conditions.

The qualification 'other things being equal' is highly significant and extremely important.

The hypothetical conditions implied by "other things being equal," are the following:—

(1) ~~The demand for money~~ (i.e., the amount of exchange work to be done by money) *to remain constant, unchanged.*

This implies

- (a) ~~Population does not change~~
- (b) ~~Production per head of the population does not change~~
- (c) ~~Percentage of consumption by producers does not change~~
- (d) ~~Percentage of exchange by barter does not change~~
- (e) ~~Rapidity of circulation of goods does not change.~~

Increase in population leading to increased production may lead to increased demand for money. Decrease in population leading to decreased production of commodities and services

* Prof. Taussig in his *Principles of Economics*, Vol. I, Chap. 30 has discussed the relation between this total purchasing power in terms of money and specie in advanced modern countries—"Where these highly elastic credit instruments (deposits and notes) are used, the connection between the total purchasing power and the quantity of "money" becomes at any given time very loose, there remains a real limitation on these instruments in the quantity of specie. This limitation comes into two ways: first, in various links of connection between the volume of deposits (and of notes elastic like deposits) and the quantity of specie; second, in a connection between prices in any one country and prices in the world at large."

may lead to decreased demand for money as the medium of exchange. Increased or decreased productivity per head of the population may lead to changes in the demand for money. If the producers consume a smaller or larger percentage of the goods produced by them than they consumed before and then sell the rest, these things will create changes in the demand for money in the country. If the people of the country exchanges smaller percentage of goods by barter than before and have a larger percentage of money exchanges, this will lead to a change in the demand for money—an increased demand for money in the country

The demand for money in a country depends directly upon the percentage of the volume of trade which is transacted directly by money. If in a country the population has not changed, production per head of the population has not changed, then the total production of commodities and services in the country has not changed, it is the same as before. Suppose, of the total volume of commodities and services produced in the country, formerly 4 per cent. was consumed by the producers themselves and 6 per cent. was exchanged by barter and the remaining 90 per cent. of the total production was exchanged by using money as the medium of exchange—and now also as regards the total production of commodities and services which has remained unchanged, the same percentage as before (4 per cent.) is consumed by the producers, the same percentage as before (6 per cent.) is exchanged by barter, and therefore the same percentage as before (90 per cent.) is exchanged by using money as medium of exchange.

So the total volume of trade of the country has not changed, and the percentage of the total volume of trade transacted by using money as the medium of exchange is the same as before.

** Then the demand for money has remained unchanged*

** As a matter of fact, in any country at any given time (referring to a point of time or a short period) practically population does not change much, nor productivity per head of the population, nor percentage consumption by producers, nor percentage of barter exchanges. Also we may regard consumption by producers and barter exchanges.*

The demand for money in the country remaining equal or unaltered, the value of money varies inversely as the supply or the quantity of money units available—provided the rapidity of circulation remains the same.

(2) Rapidity of circulation of money to remain unchanged.

as negligible factors in the economic life of modern countries. Rapidity of circulation of goods is an important factor. Rapidity of circulation of goods in any country depends upon the distribution of population between rural and urban areas, the nature of transport facilities, the character of the population, the nature of the different industries etc. Within a comparatively short time, rapidity of circulation does not change much. So we may perhaps be justified in assuming that in any country at any given time the demand for money remains practically unchanged.

The value of paper money.

"It is on this principle that paper money circulates; the whole charge for paper money may be considered as seigniorage. Though it has no intrinsic value, yet by limiting its quantity its value in exchange is as great as an equal denomination of coin or of bullion in that coin." (Ricardo). By limiting the quantity of paper money, the value of paper money can be kept on a par with that of metallic money.

The relation between the value of inconvertible paper and its quantity is sometimes expressed thus—

Other things being equal, the value of inconvertible paper varies inversely as its quantity. Such a theory about the value of inconvertible paper though generally accepted is not strictly true in all cases. An excessive issue of inconvertible paper will destroy the confidence of the people and the value of inconvertible notes will then depreciate more than in proportion to the increases in quantity. When inconvertible paper has driven metallic currency entirely out of the circulation even then it will have value provided it remains legal tender for certain purposes, e.g. the payment of taxes etc. If it ceases to be legal tender then its value may fall to zero and it will be replaced by natural money.

"Other things being equal" here means that the total quantity of commodities has not changed, and that credit transactions and the rapidity of circulation of paper money are constant.

The quantity theory of money states a relation between the quantity of money and the price-level of commodities. And in this connection instead of considering the use of credit as reducing the demand for money (as indicated above) we may consider the total supply of money available to include metallic money, paper money and cheques (credit) with which to meet the total demand for money created by the volume of trade. . . . "In a western country, the quantity of convertible common money is determined with reference to the volume of standard money in the same kind of way as the volume of bank money (cheques based upon deposits) is determined with reference to the volume of common money; namely by two factors—the habits of the people (as regards use of money) and the policy or obligations of the Government and banks (as regards money)." (Robertson).

(The rapidity of circulation of money depending upon custom and business habits of the people does not change much in a short period.) [But a doubling of the rapidity of circulation of money will have the same effect as a doubling of the quantity of money in the country. An increase in the average rapidity of circulation enables the money of a country to do a larger amount of exchange work with the same amount of money than formerly ; and so has the same effect upon the value of money as an increase in the supply of money. Increased rapidity of circulation may come from development of means of communication (e.g. railways etc.), development of banking facilities, etc.].

Finally we must remember that the entire supply of precious metals is not used as money, part of the supply is hoarded and part is used for industrial purposes. An increased use of gold in industries would diminish the total supply available for use as money. Gold is distributed between money and commodity uses so that the purchasing power of a money ounce equals the exchange value of an ounce of gold.

The cost of the precious metals (specie) in relation to their value.

Is the value of gold (used as money) determined by the marginal cost of production ?

The durability of the precious metals, the speculative character of mining and the chance discoveries of new sources of supply—these prevent the value of the precious metals from being determined by the marginal cost of production.

"It is not so true that cost at the marginal mine governs value, as it is that current value determines what sort of mine shall remain in operation and shall become the marginal mine." Tanassig, *Principles of Economics*, Vol. I., 1925, Chapter 19, page 259.

"Sometimes it is stated that the value of money depends upon its cost of production. This does not, however, involve any new principle. The only difference between money and other commodities is that the influence of cost of production upon supply, and hence upon the value, of money works itself out more slowly."

A decrease in the expense of mining, such as that which has been effected by the modern cyanide process, renders possible a far greater output. *Since the precious metals, however, are exceedingly durable, this annual increment forms only a small fraction of the entire available supply, and will not produce any immediate change in value. . . .*

Sooner or later, however, an alteration in the rate of annual increase will make itself felt. A lower cost of production of money may hence be said to raise general prices, in so far as it augments the quantity of money. *The cost-of-production theory thus resolves itself into the quantity theory.*" (Seligman—*Principles*.)

An increase in the quantity of money increases proportionately prices (and lowers the value of money), and a decrease in the quantity of money lowers proportionately prices (and increases the value of money)—only when other things are equal, remain unchanged. The influence of the quantity of money on the value of money may be and is however often counteracted by changes in these other things, viz. trade, barter, and rapidity of circulation of goods and of money etc. For example, when the quantity of money is doubled, if at the same time the volume of trade is doubled—the increase in the quantity (supply) of money will have its influence counteracted by the corresponding increase in the volume of trade (demand for money) and there will be no change in prices and in the value of money.

*A deeper and more satisfactory way of looking into the relation between the quantity of money in a country and the purchasing power of the monetary unit is found in the work of Marshall and the Cambridge School.

* Refer to Prof. Cannan's address opening the discussion on Monetary Reform at the Annual Meeting of the Royal Economic Society on April 14, reported in the *Economic Journal* for June, 1924—

"The improvement which has taken place may be shortly summarized in the statement that the relation between the quantity of currency and its purchasing power has been cleared up. There is no denying, I think, that the textbooks of years ago—not only the elementary ones—gave a very muddled, unsatisfactory account of this relationship. They asked us to think of the whole quantity of money in existence being offered in exchange for a total of commodities (and perhaps services) of which it was impossible to form any definite conception—it was not the total in existence nor the annual or weekly production nor any other total with which we are familiar. Then it was taken for granted that we should infer that the purchasing power of the money would depend on the relative variations in magnitude of the two totals, so that if the money increased while the commodities remained stationary, the purchasing power would fall. After that it was admitted that a modification was necessary because the same piece of money could be exchanged for goods more than once. To meet this it was said that the purchasing power of money depended not only on its quantity * but also on its rapidity of circulation.

Prof. Marshall on the value of a country's currency and the relation between the volume of the currency and the general level of prices.

"In every state of society there is some fraction of their income which the people find it worth while to keep in the form of currency, it may be a fifth or a tenth, or a twentieth. A large command of resources in the form of currency renders their business easy and smooth . . . ; but, on the other hand, it locks up in a barren form resources—But, whatever the state of society there is a certain volume of their resources which people of different classes, taken one with another, care to keep in the form of currency; and *if everything else remains the same, then there is this direct relation between the volume of currency and the level of prices that if one is increased by ten per cent the other also will be increased by ten per cent.* Of course, the less the proportion of their resources which people care to keep in the form of currency, the lower will be the aggregate value of the currency, that is, the higher will prices be with a given volume of currency.

This relation between the volume of the currency and the general level of prices may be changed permanently by changes in, first population and wealth which change the aggregate income; secondly by the growth of credit agencies, which substitute other means of payment for currency; thirdly by changes in the methods of transport, produc-

It has now been entirely scrapped, and we are asked to look at the matter in a much simpler way. Currency is regarded like any other durable goods, such as ships or houses, which form part of the material equipment or capital of the community. We start from its value or purchasing power as we find it at any moment, and then ask ourselves how that will be affected by changes in the supply of and the demand for currency, thinking of the supply and demand just as we think of them in regard to houses, the supply being the whole stock in existence, and the demand being furnished by people who want to hold portions of that stock.

The supply side of the matter is simple enough. Additions to the stock tend to diminish the value of the unit of currency just as additions to the stock of houses tend to diminish the value of the unit housing.

. I do not contend that this conception was wholly unknown before the war: rummaging among old lecture notes, I find that I was teaching it orally ten years before I put it in a book in 1918. But the currency troubles of the war secured its wide acceptance by experts. They saw that currency depreciation was causing enormous increases in the amount of currency held per head of inhabitants in different countries, while at the same time the purchasing power of this increased holding was greatly reduced"—Cannan, *An Economist's Protest*, 1927, pages 384-387.

tion and business generally which affect the number of hands through which commodities pass in the processes of making and dealing, and it may be temporarily modified by fluctuations of general commercial confidence and activity.

Although the purchasing power of a unit of currency varies, other things being equal, inversely with the number of units (i.e. the quantity of money); yet an increased use of inconvertible paper currency may lower its credit, and therefore lessen the amount of ready purchasing power which the people care to hold. That is, it may lower the value of each of the units more than in proportion to the increase of their number.

The quantity doctrine is helpful as far as it goes, but it does not indicate what are the other things which must be assumed to be equal in order to justify the proposition and it does not explain the causes which govern rapidity of circulation.

It (the Quantity Theory) is almost a truism

The other things, that must remain equal for the purposes of the statement, include (a) the population; (b) the amount of business transacted per head of the population; (c) the percentage of that business which is effected directly by money; and (d) the efficiency (or average rapidity of circulation) of money. Only if these conditions are reckoned in, can the doctrine come under investigation and if they are reckoned the doctrine is almost a truism.

Symbolical expression of the theory of the value of money.

(a) Prof. Fisher's formula.

Prof. Fisher sums up the quantity theory in the following formula

$$\frac{MV + M'V'}{T} = P$$

In this formula

T = the trade, i.e., the quantity of exchanging work to be done.

P = the price-level of commodities.

M = quantity of money.

M' = the quantity of credit. (According to Prof. Fisher M' bears a definite proportion to M; and the proportion of M to M' in any country depends upon the concentration of population, scale of business, systems of payment in use, etc.)

V = velocity of circulation of money.

V' = velocity of circulation of credit.

The formula means that given T, V, M' V' (i.e. the volume of trade, the velocity of circulation of money, the amount of credit and the velocity of circulation of credit—all things remaining the same), P (price-level) rises proportionately with an increase in the supply of M (money), P falls proportionately with a decrease in the supply of M.

If M is trebled then P also will be trebled; if M is halved (if the quantity of money is reduced by half) then the price level will be also halved.

Other things being equal, P the price level (of commodities) depends upon and varies directly as the quantity of money.

(2) The Quantity Theory re-stated by Prof. Keynes in *A Tract on Monetary Reform*.

In a Tract on Monetary Reform Prof. Keynes maintains that under modern conditions the quantity of money should be deliberately regulated by Governments and Central Banks to keep trade, prices and employment stable; and he re-states the Quantity Theory.

The Quantity Theory flows from the fact that money as such has no utility except what is derived from its exchange-value

The number of notes which the public ordinarily have on hand is determined by the amount of the purchasing power which it suits them to hold or to carry about and by nothing else. The amount of this purchasing power depends partly on their wealth, partly on their habits

Let us assume that the public require to hold an amount of money having a purchasing power over k consumption units. Let there be n currency notes or other forms of cash in circulation with the public, and let p be the price of each consumption unit (i.e. p is the index number of the cost of living), then it follows from the above that

$$n = pk.$$

This is the famous Quantity Theory of Money So long as k remains unchanged n and p rise and fall together: that is to say, the greater or the fewer the number of currency notes, higher or the lower is the price-level in the same proportion

Let us assume that the public, including the business world, find it convenient to keep the equivalent of k consumption units in cash and of a further k' available at their banks against cheques, and that the banks keep in cash a proportion r of their potential liabilities (k') to the public. Our equation then becomes

$$n = p (k + rk').$$

So long as k , k' and r , remain unchanged, we have the same result as before, namely, that n and p rise and fall together. The proportion between k and k' depends on the banking arrangements of the public; the absolute value of these on their habits generally; and the value of r on the reserve practices of banks. Thus, as long as these are unaltered, we still have a direct relation between the quantity of cash (n) and the level of prices (p)

The theory has often been expounded on the further assumption that a mere change in the quantity of the currency cannot affect k , r , k' . . .

Now "in the long run" this is probably true

In actual experience, a change of n is liable to have a reaction both on k and k' and on r .

The moral of this discussion is that the price-level is not mysterious, but is governed by a few, definite, analysable influences. Two of these n and r , are under the direct control (or ought to be) of the central banking authorities. The third, namely k and k' , is not directly controllable, and depends on the mood of the public and the business world. The business of stabilising the price-level, not merely over long periods but so as also to avoid cyclical fluctuations, consists partly in exercising a stabilising influence over k and k' and, in so far as this falls or is impracticable in deliberately varying n and r so as to counter-balance the movement of k and k'

The usual method of exercising a stabilising influence over k and k' , especially over k' , is that of the bank-rate

But it is doubtful whether bank-rate by itself is always a powerful enough instrument, and if we are to achieve stability, we must be prepared to vary n and r on occasion.

[Mr. Hartley Withers and others hold that the stabilisation of the value of money and of the price-level is not always the only desirable ideal, and that this stabilisation cannot be always practically realised by a suitable bank rate policy and the action of Governments and Central Banks.]

For Keynes's recent forms of the Equations, refer to J. M. Keynes, *A Treatise on Money*, Vol. V. Book III.

Historical verification of the Quantity Theory.

The Quantity Theory can be historically and statistically verified. Prices in Europe by the middle of the 16th century rose to double or treble what prices had been in the beginning of the 12th century: and this general rise of prices was due chiefly to the great increase in the supply of precious metals from the discovery and exploitation of America.

The following facts give good historical evidence in support of the Quantity Theory of Money.

Period Price-level of
 Commodities.

Causes.

1849-74 Rising prices

Large supplies of gold from the new mines in Australia and California increased the quantity of money, brought about a fall in the

<i>Period.</i>	<i>Price-level of Commodities.</i>	<i>Causes.</i>
		value of money and a rise in the prices of commodities.
1874-96	Falling prices	A decrease in the production from the mines combined with a greatly increased demand for gold (Germany adopted the gold standard in 1871 and Italy two years later) tended to bring about a rise in the value of money and falling prices of commodities. Falling prices were further accentuated by an immense increase in the output of commodities.
1914-20	Unparalleled rise in prices	During and after the Great War, the quantity of money was enormously increased by issues of immense quantities of inconvertible paper money bringing about a great fall in the value of money and unparalleled rise in the prices of commodities; and also there was an enormous expansion in the use of credit, specially by the Government. At the same time the quantity of goods was restricted and also there was a destruction of goods and services.
1920-22	Falling prices	The preceding rise in prices brought about a great increase in the production of goods to secure the advantage of the high prices. This great increase in the production of commodities tended to bring about a fall in their prices, and falling prices of commodities were accentuated in Britain by the

*Period. Price-level of
Commodities*

Causes.

British Government's adoption of the plan of deflation and by the restriction of credit facilities by the banks.

1929-32 Falling prices

The world economic depression, starting in 1929 continued up to the present and still expected to continue, has brought about a great fall in the prices of agricultural products, minerals, manufactures in all countries of the world. The world economic depression has many causes. But an important cause consists in the world shortage of gold production as compared with the world demand and to a greater extent in the *maldistribution of gold*, the United States and France having grabbed the greater part of the world supply of gold.

The Quantity Theory of Money in its application to India.

The quantity theory in its bald and unqualified form (namely that the value of money rises or falls proportionately with a decrease or increase in the supply of money) *does not apply to India, nor to any other modern country.* This is shown by an examination of Index Numbers. Index Numbers indicate that in India the total currency in circulation increased from 100 in the year 1894 to 164 in the year 1912 ; but prices in the same period did not rise in the same proportion, but rose from 100 to only 138. The fall in the value of money (and the rise in prices) was not proportionate to the increase in money supply.

In modern India, thus the value of money does not depend only upon the quantity of money.

The increase in the average rapidity of circulation due to improved means of communication etc., the increasing use of

credit resulting from better banking facilities, a very considerable use of the precious metals for the purpose of making ornaments etc., and for hoarding, changes in the volume of business—all these factors affect the influence exercised by the quantity of metallic money upon the value of money and prices in India. So the quantity theory to be made applicable to India must be stated with suitable limitations and not in its unqualified form.

Objections against the Quantity Theory.

Objections have been advanced against the Quantity Theory.

(A) Objectors to the Quantity Theory have sometimes maintained that *prices should be regarded as causes rather than as effects*. High prices increase the supply of money, and low prices bring about a decrease in the money supply—changes in prices are the causes and not effects of changes in the quantity of money.

This objection is regarded as unsound.

"So far from its being true, that high prices cause increased supply of money, it is true that money avoids the place and the time of high prices and seeks the place and time of low prices, thereby mitigating the inequality of price levels." (Fisher—*The Purchasing Power of Money*, Chap. viii).

(B) The Quantity Theory makes the condition "other things being equal." *But other things are not equal*—in a modern society these other things change, there are changes in the volume of trade due to growth of population and industry, changes in rapidity of circulation (for which even rough figures are not available in all countries) and changes as regards credit in all its shapes. The part played by gold is very small as compared with credit in making payment in internal and in foreign trade, and so it is not proper to lay so much emphasis on the influence of gold in relation to prices; the definite proportion between gold and credit is also denied by opponents of the Quantity Theory. Emphasising the influence of gold upon prices and neglecting the more important credit factor—"this seems something like calculating the depth of water in a harbour by the rainfall and the inflow of the river, and taking no account of the flow of the tides."

Prof. Laughlin rejects the Quantity Theory and Prof. Nicholson is very critical about it.

Conclusion on the Quantity Theory.

Mr. Robertson in his *Money* states (and he holds the view maintained by many English economists at the present day) "*No longer either a triumphant credo or a pestilent heresy, the quantity theory of money remains as a dowdy but serviceable platitude.*" and he notes that

the quantity theory asserts a curious truth about the determination of the value of money, which constitutes a real ground of distinction between money and every other thing, and that this truth is one which it is well to bear firmly in mind examining the complex relations between the quantity of money and the level of prices which prevail in actual life.

Prof. Cannan has his own view as to the way in which the Quantity Theory should be expressed. He maintains that the demand for currency is furnished "not by the number and amount of *transactions* but by the ability and willingness of persons to *hold* currency, in the same way as we think of the demand for houses as coming not from the persons who buy and resell or lease and sub-lease houses but from the persons who occupy houses" (*Economic Journal*, Dec. 1921).

III. Effects of changes in the Value of Money.

Changes in the value of money—depreciation and appreciation. *Inflation and deflation.

Appreciation of money means a rise in the value of money, an increase in its purchasing power.

*** Inflation and Depreciation of Money (1914—1920) during and after the War and the Deflation and Appreciation of Money (1920—1922). Causes.**

During and after the war (1914-1920) in Europe there was an enormous increase in the supply of money (due largely to immense issues of inconvertible paper money by the different European countries), a decrease in the supply of commodities and an enormous depreciation of money and an enormous rise in the prices of commodities.* "Where the supply of commodities has been reduced by ten per cent. the means of payment have generally been increased by at least as many hundreds per cent

The rise of prices has been very different in different countries. As soon as the common metallic standard is abandoned, and each country has got its own (inconvertible) paper currency the price-level of each country becomes a fact for itself, independent of the price-levels of other countries."

As regards the process of inflation. "The War has been financed by all countries involved to a great extent by means of creating more money . . . partly in the form of new issues of bank notes or state paper money partly in the form of extended bank credits which could be used as means of payment The result of the creation of new money has been, in both cases that a new buying capacity has been put at the disposal of the Government. The total buying capacity of the

* Cassel—*The World's Monetary Problems*.

(Depreciation of money means a fall in the value of money, a decrease in its purchasing power.)

(When the supply of money is increased to such an extent that general prices (of commodities) are raised—there is said to be an inflation of currency. When the supply of money relatively to the demand decreases to such an extent that prices in general fall—there is said to be a contraction (or deflation) of the currency.)

(Such contraction or inflation is said to be natural when it depends upon natural conditions affecting the supply of precious metals. When the inflation is due not to natural conditions but is due to the action of a Government issuing inconvertible paper or debased metallic currency in excessive amounts—then the inflation is said to be artificial.)

(Deflation is, shortly, a process by which the internal value of the monetary unit is increased. This means a deliberate raising of the purchasing power of money in regard to commodities and services—i.e., a “general and uniform reduction of prices, wages and salaries as measured in terms of the monetary unit.”) (Cassel).

(Deflation by bringing about a rise in the value of money injures debtors who in repaying the same amount of money

community having in this way been increased without a corresponding increase in the commodities to be bought, a general rise in prices has followed In this way an inflation has taken place in every one of the countries involved in the war.”

The process of inflation did not end with the war. On the contrary, in many cases it continued on a larger scale. The actual process of inflation in most European countries was the combined result of (a) an artificial creation of purchasing power in order to finance a government expenditure beyond the real capacity of the country and (b) a falsification of the money market by a too low rate of interest, in both cases with the assistance of an arbitrary supply of legal tenders.

In the period 1920-1922 there was an appreciation of money and falling prices of commodities. A decrease in the quantity of money brought about by deflation in the United States, Britain, France, Japan and the Scandinavian countries brought about a rise (appreciation) in the value of money and a fall in the general level of prices of commodities.

they borrowed return to the creditors a larger purchasing power in terms of commodities ; and it correspondingly benefits creditors.)

(Inflation, on the other hand, by bringing about a fall in the value of money injures the creditor class in a community ; and it correspondingly benefits debtors.)

Evils of Artificial Inflation.

Artificial inflation resulting from excessive issue of inconvertible paper produces many evils and these are described on pages 93, 94.

Artificial inflation of this sort is also a great hindrance in international trade. Foreigners have no faith in the depreciating paper money of another nation and so the foreign trade of the country is injuriously affected.

The last great world-war brought about the issue of enormous quantities of inconvertible paper money by different governments, and this led to inflation and all its evils

Some causes of depreciation of money.

(We have depreciation of the value of money when the same quantity of money buys a smaller number of the units of goods than before.)

And this depreciation may be due to different causes, e.g.

(1) The quantity of money remains fixed, and there is a decrease in the supply of commodities. This happens very rarely.

(2) The quantity of money has increased, but the volume of goods remains much the same. This is more commonly found. Depreciation due to this cause was found during and after the War in Britain, India etc., and in extreme form in Germany, Russia and the States formed out of the ruins of the last Austro-Hungarian Empire.

Some causes of appreciation of money.

(We have an appreciation of the value of money when the same quantity of gold (or other money) buys a larger quantity

of goods than before ; and this appreciation may be due to different causes, e.g.)

(1) The quantity of money remains fixed or increases, but there is an increase or a more than proportionate increase in the supply of commodities. This is more common.

(2) The quantity of money has diminished, but the volume of goods remains much the same.

The increased supply of commodities will be often due to better methods of production ; and the diminished supply of precious metals for monetary purposes may be due to exhaustion of mines or to economic conditions making the mining industries comparatively unprofitable or to wars interfering with mineral production in a country or to an increased demand for gold in other countries for monetary or for industrial purposes etc.

Effects of changes in the Value of Money.

(All men are interested in rise and fall in prices of commodities and changes in the value of money. In a community most men are debtors or creditors or both, some are producers or businessmen, a great many are wage-earners and many are persons with fixed incomes (from salaries, pensions, or investments in National Debts, etc.) and all persons are consumers. How are these different classes affected by changes in the value of money and rise and fall in prices of commodities?)

Depreciation of Money (and rising prices of commodities).

In most cases rising prices are due to increase in the quantity of money—metallic money or paper money. The effects of slowly rising prices and of rapidly rising prices are not exactly the same.

And under rising prices the economic losses and gains of the different classes in a nation will differ according to their comparative economic strength—will change with changes in economic strength. For example, in England, the labourers are stronger, better organised than before, so they lose less now under rising prices than before (page 48).

(A) Advantages of Depreciation of Money (and rising prices).

(1) The rising prices (of commodities) increase the profits of the enterprisers and thus stimulate business.

Profits of the producers are increased because cost of production does not increase as quickly and to the same extent as prices; and so the rise in prices increases the margin between the price of the commodity and its cost.

Moderate and slowly rising prices often will do a great deal of good by encouraging producers, stimulating production and employment. Producers are benefited, also labourers get steady and increased employment. (Large and rapidly rising prices lead to speculation and crisis and serious evils).

(2) A moderate rise in prices may help to increase efficiency of production in a country.

Prof. Ely points out that the encouragement given by rising prices leads to the trial of new methods of production and to a general freeing of the industrial organization and methods from the restraints of habits and traditions.

(3) Creditors lose and debtors gain. The debtor though repaying the same amount of money that he borrowed is returning a less value in terms of commodities because the purchasing power of money has fallen.

† Enterprisers work largely with borrowed money and as debtors they benefit by the fall in the value of money.

* Ely—*Outlines of Economics*.

† The advantages of enterprisers from high prices "do not arise chiefly from the fact that business men are debtors. They are both debtors and creditors The chief explanation of the optimism and activity which business men in general show in times of rising prices is found in the relation which they as a class hold to the labourers as a class That wages go up more slowly than prices is one of the best attested facts in economic history It is a familiar experience that those business men gain most in periods of rising prices whose operations involve in largest degree the payment of wages.

Business men secure real and substantial advantages."

"In part, to be sure, that prosperity is rather apparent than real. People so habitually reckon their incomes and resources in terms of money that they think themselves better off when money incomes go up. They disregard for a time at least that their expenses go up also." (Tausig—*Principles of Economics*, Vol. I., Chapter 22, pages 297, 298.

The creditors however gain some compensation through an increased rate of interest. When prices are rising, the rate of interest generally tends to rise—the adjustment of the rate of interest to prices is mainly unconscious, but still producers are able and willing to pay a higher rate of interest with rising prices for their commodities and so there is a rise in the rate of interest.

Disadvantages of Depreciation.

(1) A period of rising prices (and specially rapidly rising prices) often leads to a crisis and its attendant evils. In such a period profits are abnormally high. The result is that there is excessive speculation, loans are made freely even to incompetent entrepreneurs and there is inefficient work and over-production.

(2) How the creditors are injured by the rising prices—this has been already noticed at

(3) Other things being equal, consumers will lose because they will have to pay higher prices for commodities.

(4) Persons with fixed incomes (e.g. persons receiving fixed salaries or pensions) suffer because the same money income will now purchase a smaller amount of commodities than before.

(5) Money wages do not generally rise as quickly as prices; if prices rise faster than money wages at a particular time, the real wages of labour are obviously falling and in a period of rapidly falling prices the labourers are seriously injured.

With large and rapid rise in prices, creditors and persons with fixed incomes also suffer very much.

(Of course if in a country the labourers are strong and well-organised, they will compel the employers to raise wages with rising prices—and so they may lose little. This is something like the position of the labourers in England during the world-war and for some time after—as Mr. Keynes suggests. See page 50. But the labourers in a backward country like India lose heavily).

Appreciation of Money and falling prices.

(A) Disadvantages of Appreciation of Money and falling prices.

Appreciation will produce serious evils if it brings about a sudden and serious fall in prices and discourages production and increases unemployment: then labourers will suffer greatly and also capitalists and entrepreneurs.

With falling prices of commodities (and rising value of money) the tax-payers suffer—they paying the same sum of money in taxes as before are paying to the State a larger purchasing power in terms of commodities. Also the burden of the National Debt on the people is increased with rise in the value of money. All debtors lose with the appreciation of money.

For **Falling Prices and the World Economic Depression**, refer to page 56.

(B) Advantages of Appreciation to some classes of the nation.

(1) The creditor (though getting back from the debtor the same amount of money) will now get from the debtor a higher value in terms of commodities because of the increased purchasing power of money. (The debtor loses; but he may get some partial compensation for his loss in a diminished rate of interest).

(1) Persons with fixed incomes gain by an increase in the purchasing power of their incomes.

(3) Wage-earners. With slowly falling prices, labourers may get employment and practically at the old rate of wages; and they gain because the same money wages will now buy more commodities on account of the increased purchasing power of money.

(We must distinguish between slowly falling prices and rapidly falling prices. The disadvantages are serious as regards rapidly falling prices.) (With rapidly falling prices and heavy fall, producers of crops and manufacturers etc. suffer seriously) they curtail production, dismiss large numbers of labourers and

try to reduce wages of the labourers who are employed. So the labourers also suffer very greatly.

The normal case of slowly falling prices.

The normal case of appreciation of money and slowly falling prices, is that of a progressive community with a growing population producing at a gradually decreasing cost of production on account of improvements.

Under these circumstances, persons with fixed incomes (*i.e.* persons getting fixed salaries or pensions) gain through the falling prices. The same money income will now buy a larger number of units of commodities.

The *entrepreneur* will gain from the diminished cost, the *capitalists*, the *consumers* and the wage-earners. The decreased cost of production stimulates enterprisers by increased profits and increases their demand for capital and forces up the rate of interest—thus the capitalists benefit. The competition between producers makes them lower prices and thus gives the consumer an advantage; and at the same time it leads them to offer higher wages to labourers. (This is the opinion of some economists).

Effects of Depreciation (due to inflation) of Money in 1914—1920 and Appreciation (due to deflation) of Money in 1920—1922.

The effects of depreciation and appreciation—their advantages and disadvantages—have been already noticed. As regards the wage-earner (specially in Britain and the United States, where he occupies a fairly strong position and is well-organised), he does not lose now so much as formerly during a period of rising prices, and sometimes actually he gains because he can compel the employer to increase his money wages (and his real wages) during a period of brisk business and rising prices.

As regards the effects of inflation and deflation on the distribution and production of wealth in a country, the following extract from Mr. Keynes's *Tract on Monetary Reform** may be quoted: "Inflation redistributes wealth in a manner very injurious to the investor, very beneficial to the business man, and probably, in modern industrial conditions, beneficial on the whole to the earner (wage-earner) . . . rising prices and falling prices have each their characteristic disadvantage. The Inflation which causes rising prices means Injustice to

* In *Monetary Reform* (Chapters I and II) Mr. Keynes ably discusses the consequences to society of changes in the value of Money

I. As affecting Distribution

1. The Investor
2. The Business Man
3. The Earner

II. As affecting Production;
and also Public Finance in relation to changes in the value of Money

individuals and classes,—particularly to investors; and is therefore unfavourable to saving. The deflation which causes falling prices means impoverishment to labour and to enterprise by leading entrepreneurs to restrict production, in their endeavour to avoid loss to themselves and is therefore disastrous to employment. The counterparts are, of course, also true,—namely that *Deflation means Injustice to borrowers, and that Inflation leads to the over-stimulation of industrial activity Thus Inflation is unjust and Deflation is inexpedient. Of the two perhaps Deflation is, if we rule out exaggerated inflations such as that of Germany, the worse, because it is worse in an impoverished world, to provoke unemployment than to disappoint the rentier.*” *Deflation by decreasing the quantity of money and by bringing about a fall in the prices of commodities (1) discourages enterprisers and production, (2) reduces trade and employment for labour and capital and (3) increases the burden of all debts including the huge national debts created by the war; it benefits generally the non-producers (e.g., holders of national debts etc.) at the expense of the active elements of the State and so deflation is strongly condemned by a whole host of distinguished economists including men like Mr J. M. Keynes and Prof. Gustav Cassel*

High and low prices, rising and falling prices.

If prices of all commodities and services are twice as high as before, and every individual has his income doubled—then every one is as well-off as before, is able to purchase the same amount of commodities and services. So high prices (with all incomes adjusted) are not an evil. Nor low prices. *But under actual conditions, the incomes are not adjusted.* The evil lies in rising prices and also in falling prices—(with incomes unadjusted)—as some individuals and classes gain at the expense of others.

***Are rising, falling or steady prices the best?**

There are advocates of rising prices, there are advocates of falling prices and there are advocates of steady or stable prices.

“Supposing that man continues to advance from triumph to triumph in his struggle with nature: would it not be desirable that those whose money incomes are relatively fixed by law or custom, and who are not as a rule the most self-assertive members of the community, should receive automatically a share in the fruits of progress in the form of falling prices, even though they had no definite expectation of doing so? Supposing, on the other hand, that the world should fail to solve the problem of mechanical power, or that the Great War should prove to have been the first of a series of disastrous explosions, can

(1) (The advocates of rising prices maintain that a *gently rising price-level* and slowly rising prices stimulate enterprisers and production, increase trade and employment for labour and capital, empty the work-houses and fill the factories and ship-yards and thus benefit the nation as a whole (without causing much injury to creditors, persons with fixed incomes and consumers generally))

(2) It has been already seen however that under certain circumstances rising prices lead to serious evils. Some persons are of opinion that the normal case of *slowly falling prices* as described on page 50 is good for the community as a whole. In this connection the high authority of Dr. Marshall may be quoted who stated before a Royal Commission that "it wants very much stronger statistical evidence than one yet has to prove that the fall in prices diminishes perceptibly or in the long run, the total productivity of industry."

(3) Many distinguished economists (Cassel, Keynes,

it be maintained that those with fixed incomes should be allowed, as would happen if prices were kept stable, to absorb always the same absolute amount, and consequently a greater proportionate amount, of society's real income of goods and services?

It is on such grounds that a case can be made out for a standard of value which should remain stable not in terms of goods in general, but in terms of productive power.

From the standpoint of social justice and harmony even from the standpoint of theoretical simplicity of working—we should be strongly inclined to accept this solution."

"On the whole, then, if we were perfectly free to choose, we should perhaps stick fairly closely to the obvious decision to keep the price-level stable. But we should force ourselves to interpret that decision with care: We should be prepared either to suspend it, or to compel the overhauling of money contracts, in exceptional circumstances: and so long at any rate as we preserve the system variously known as Private Enterprise and as Wage Slavery, we should not refuse to wink at a little judicious use of the money-pump, if the tyres of industry seemed to be sagging unduly."—Robertson, *Money*, p. 140.

Robertson's eminently sensible conclusion is that broadly we should aim at keeping the price level stable; in exceptional circumstances the price level should vary inversely with productive power and occasionally moderate expansion of credit and currency bringing about a gently rising price level, may be desirable to give needed encouragement to producers.

"Both rising and falling prices create an unstable equilibrium which means disturbance in industry and unequal gains or losses to different classes. It is not high or low prices as such which do the harm, but rising or falling prices." (Seligman—*Principles*.)

Hawtrey and others) favour steady or stable prices ; they maintain that prices, which neither rise nor fall in general and are undisturbed by fluctuations, are best on the whole for a community. *Steady prices* (comparative stability in the value of money with stability of prices of commodities in general) *do away with the uncertainty which large changes in prices cause to creditors and debtors, entrepreneurs, wage-earners, consumers, etc.* They avoid undeserved gains and losses to particular sections of the population.

If the stabilisers succeed fully in persuading nations and governments (they have succeeded already to an important extent) that broadly stabilisation is in the economic interest of every nation, also if they further succeed in perfecting the technique of stabilisation and helping the nations to realise it in practice, then these undesirable fluctuations as regards the values of the moneys of all countries will stop and monetary systems as regards their large fluctuations in value will have to say

"Our revels now are ended"*

Broadly speaking, steady prices promote stability of production, trade, employment and general business conditions.

Keynes and many of his fellow-stabilisers declare that stable prices are to be secured not by a gold standard (because of the present and future fluctuations in the supply of, and demand for gold in the world) but under a regulated paper standard under which the government and the central bank of a country will adjust the quantity of money to secure stability of prices, production, trade and employment.

Practical businessmen and politicians in Britain brought about the restoration of the gold standard in Britain in 1925 by a certain measure of deflation bringing about a decrease in the quantity of money, a rise (appreciation) in the value of money and falling prices of commodities.

What are the possible occasions when the price of an article is expected to go up? (C. U. 1930).

(1) The price of a commodity (in common with other commodities) rises when the supply of purchasing power (metallic money, paper

* Shakespeare, *The Tempest*, VI. i.

money, credit and their velocity of circulation) increases to a greater extent than the demand for purchasing power in the country. The demand for purchasing power depends upon the volume of commodities and their velocity of circulation. These things have been discussed in the quantity theory of money in relation to prices. During the world-war the price of almost every commodity rose high in Europe, America and other parts of the world due to the vast expansion of money and credit. The rise in price was due in some part to the reduced production of commodities in belligerent countries, but it was due very greatly to the vastly increased supply of purchasing power.

(2) As already considered in the chapters on Value and Markets, Vol. I, the price of a commodity may rise on account of conditions affecting its own demand and supply without a rise in the price of commodities in general in the country.

(a) Monopoly conditions.

When a commodity is produced under monopoly conditions, the producer experimenting with the price in the market, may bring about a rise in the price much above its cost of production, if the commodity is subject to diminishing return and has got an inelastic demand. The monopolist is able to do this provided he has got sufficient monopoly power, has not to fear competition or regulation by the State. (Refer to the chapters on Monopoly Value in Vol. I).

(b) Competitive conditions.

Suppose different producers are producing under conditions of competition a commodity for the same market.

Short-period market.

Whether the commodity is produced under conditions of diminishing return or even increasing return, a short-period increase in the demand for the commodity generally brings about a rise in its price. To meet the short-period increase in demand, the increased supply in the short period has to be produced with practically the existing supply of labour, capital, organization in the industry and at increased cost per unit of the commodity by making the labourers, technicians, managers, etc., work overtime at increased rates of wages, using old capital some of which is imperfectly adapted to the work, etc. In the short period, there is practically no time to attract supplies of labour, capital, organisation to the industry from other industries. Marshall speaks "of the almost universal law that the term Normal being taken to refer to a short period of time an increase in the amount demanded raises the normal supply price. This law is almost universal even as regards industries which in long periods follow the tendency to increasing return."—Marshall, *Principles of Economics*, Book V. Chap. V. §4.

Long-period market.

As already discussed in Vol. I, when a commodity is produced under conditions of diminishing return, a long-period increase in demand will bring about a rise in its price. (As regards a commodity produced under conditions of increasing return, a long-period increase in demand will bring about a fall in its price.)

Changes in the price level in relation to changes in the rate of interest. (C. U. 1931.)

Changes in the price level as causes bring about as effects changes in the rate of interest. When a lender lends ten thousand pounds and gets repayment after two years when the price level has increased (and the value of money has decreased), he is getting back the same number of pounds, but less purchasing power. So with the expectation of rising prices and falling value of money, the lender will try to get a higher rate of interest to compensate him for the loss of purchasing power as regards his principal sum when repaid to him. So a rising price level tends to bring about a rising rate of interest. A falling price level with increasing value of money makes the borrower suffer loss because of the increased purchasing power he has to pay when he repays the same sum of money that he borrowed. So with expectation of falling prices and rising value of money, the borrower will seek compensation in a lower rate of interest when he has to borrow. So a falling price level tends to bring about a falling rate of interest. The rise or fall in the rate of interest does not bring about the exact compensation because foresight on the part of lenders and borrowers and competition between lenders and borrowers are not perfect.

Also a change in the rate of interest as a cause brings about changes in the price level. When banks are lending at a lower rate of interest, businessmen will be borrowing more freely from the banks and with this increasing supply of purchasing power in the country, the price level of commodities in general tends to rise. When the banks raise the rate of interest, businessmen are discouraged by the higher rate and borrow less freely, and with lessened supply of purchasing power in the country, the price level tends to fall.

Effects of an arbitrary lowering of the price of an article below its competitive level by a government decree. (C. U. 1930.)

During the last world war, price of commodities rose very high. Governments sometimes tried to keep the prices of some commodities within certain limits.

Governments may try and try successfully to keep the prices of important consumable commodities and raw materials within reasonable limits and to check undue profiteering (masquerading as competition).

But governments are not usually so foolish as to fix the price arbitrarily below the competitive cost of production.

In war time as well as in peace time, the efforts of a government to lower arbitrarily the price of an article below its competitive cost of production will end in failure. If a government is so stupid as to fix the price of a commodity arbitrarily below its cost of production, this will lead to losses for the producers, will reduce the supply of the commodity and, persisted in, will ultimately bring about stoppage of production and extinction of supply. If the consumers have a strong demand for the commodity, they will pay the price which will cover the cost of production for the producers, and if necessary, there will be secret trading so that the government might not know. Indeed, the risk of secret trading may bring about some rise in the price above the cost of production.

Falling Prices and the World Economic Depression (1929—).

The world economic depression shows the evil effect of large and rapidly falling prices on a world-wide scale. Prices of agricultural products, minerals, manufactures have fallen heavily in all countries. The prices of agricultural products have fallen more heavily than the prices of manufactures. Falling prices have brought large losses to producers in all countries, have checked production, have led to wagecut, also to the unemployment of many millions of labourers in different countries. The hardships, suffered by labouring masses, are very great. In England three millions are unemployed, in Germany six millions, in the United States twelve millions. Producers of crops, manufacturers, etc. all over the world have been hard hit by falling prices and the burdens of their debts and interest payments have been increased by the rising value of money. The foreign trade of the world has been greatly decreased. Currencies have been seriously dislocated. Many leading countries including Britain, U. S. A., Japan have been compelled to abandon the gold standard. Many governments have big budget deficits due to the impoverishment of nations and the burdens of taxation and national debts on the peoples of the world have become very heavy with falling prices (and the rising value of money).

Proposals to raise the price level in different countries and the world price level and then to stabilize the price level.

The World Economic Conference in relation to the raising of the price level and also restoring exchange stability between the currencies of different countries. ,

The world economic depression has brought about a serious fall in the price level of commodities in different countries and so in the world price level. This has led to huge and unprecedented losses and damage to producers, labourers, governments all over the world. So the leading economists are of opinion that the price level should be raised to a more normal position, thus giving the necessary encouragement to producers, decreasing unemployment and improving the condition of the finances of the governments of different countries. Then the price level should be stabilized by appropriate monetary and other measures and by the international co-operation of the central banks in different countries.

The world economic depression started in the year 1929.* So many economists hold that the present price level should be raised to the price level of 1929 and the attempt should be made to stabilize at that price level. The subsequent stability in the price level will avoid the disadvantages of rising prices and also falling prices described on pages 48, 49.

In the World Economic Conference held in 1933, there are differences of opinion on these questions as on other questions. France and other countries still on the gold standard—the gold “bloc” or the gold nations—wanted restoration of exchange stability between the currencies of different countries and they wanted this restoration to be brought about by the restoration of the gold standard in the non-gold countries of to-day. They are not so strongly in favour of the raising

* “I should like to see gold prices brought back to the level at which they stood in 1929 before the depression began. And after that I should like to see an approximate stability in the general price level. If the first could be achieved a new stimulus would be given to enterprise, and the burden of debt, both public and private, would be lightened. If the second were possible, recovery, once attained, would have a much better chance of being permanent.”—Sir Arthur Salter in *The World's Economic Crisis and the Way of Escape* (1932) p. 34.

“The countries off the gold standard.....must first raise their price level at least some half-way up to the price level of 1929”—Professor Gustav Cassel's *Memorandum of Dissent to the Report of the Gold Delegation of the Financial Committee of the League of Nations.*

of the price level as the United States of America, their bitter experience of inflation in the past being remembered. The United States on the other hand wanted first a great rise in the price level in the internal price level of the country to give help and encouragement to producers and labourers in the United States. The rise in the price level is to be brought about by expansion of credit and currency. The United States did not want for the present exchange stability as regards the value of the dollar in terms of foreign currencies.

THE CIRCULATION OF MONEY—GRESHAM'S LAW.

(A law about the circulation of money—metallic money and paper money).

This law is named after Sir Thomas Gresham,* one of the financial advisers of Queen Elizabeth who called attention to the operation of this law in the currency of his own time.

The law is this—*bad money drives good money out of the circulation*. When two kinds of money (one bad and the other good) are in circulation in a country at the same time, the bad money will remain in the circulation and the good money will be driven out of the circulation.

We have to explain (1) why bad money remains in circulation and (2) why good money retires from the circulation.

(Bad money will remain in circulation because most men will make their payments with bad money keeping the good money for themselves, so long as bad money is not refused.

Good money will disappear from circulation because it will have higher value out of the circulation than in the circulation ; and so people will gain by taking good money from the circulation and by using it for industrial and other purposes (viz. melt-

* The law was in fact known much earlier than Gresham's time, and it seemed to have been recognised even among the ancient Greeks. In the "Frogs" of Aristophanes, a great Greek comic dramatist, we find the following :

"For your old and standard pieces, valued and approved and tried,
Here among the Grecian nations and in all the world besides
Recognised in every realm for trusty stamp and pure assay,
Are rejected and abandoned for the trash of yesterday ;
For a vile, adulterate issue, drossy, counterfeit and base
Which the traffic of the City passes current in their place."

ing, hoarding and also payments abroad) where good money has a value higher than it has in the currency circulation.

I. How does good money disappear?

In a country the good money will be driven from circulation in the three following ways :

(a) Sale by weight.

Suppose a rise in the value of gold in the market makes the value of the gold coin as metal greater than its legal value as a coin. The result is that people will make a profit by melting gold coins and selling the gold as metal. In this way a considerable part of good money is often driven out of circulation.

(b) Hoarding

When people want to hoard money for future emergencies, they will naturally hoard the good money and not the bad money. A portion of the good money may be hoarded and thus be driven out of circulation.

(c) Payment abroad.

Some portion of the good money of a country may be driven out of circulation by payments abroad.

A country has sometimes to remit coins to make foreign payments rising out of international trade and other international transactions.

Now for these foreign payments, good money will be used in preference to bad money. The reason is this: Foreign creditors will take bad money as well as good money only at their value as metal; and so a smaller number of good coins would be required to make the same foreign payment for which a larger number of bad coins would be wanted. The foreign creditors will therefore be paid in good coins. Bad coins will be retained for the internal circulation of a country where they have the same value as good coins (so long as the bad coins are legal tender and are accepted by people at their coin value).

II. The extent of application of Gresham's law.

Gresham's law applies to the following cases in which bad money drives out good money :—

(a) *When a depreciated paper money is in circulation with a metallic money, the depreciated paper money is bad money and the metallic money is good money. The metallic money will be driven out of circulation by the depreciated paper money.*

(b) *When a worn money as well as a newly coined full weight money of the same metal are in circulation at the same time, the worn money is bad money, and the newly coined money is good money. In this case the newly coined money will be driven out of circulation.*

The law was observed by Sir Thomas Gresham under these circumstances.

(c) *When two metals, gold and silver, are in circulation and the value of one of them is higher in the currency than in the market for metals. Suppose one ounce of gold in the form of coin is equal to sixteen ounces of silver in coined form, but as metal one ounce of gold purchases only fifteen ounces of silver, then gold becomes bad money (i.e. overvalued money having higher value as coin than as metal) and silver becomes good money, and silver is driven out of circulation. Silver is withdrawn from the circulation because it has a higher value as metal than the value it has in the circulation in its coined form*

(This third case often happens under bimetallism).

It will be seen that in this case (c) "bad money" refers to money in which the metallic value of the coin is lower than its legal value as coin, and 'good money' refers to money in which the metallic value of the coin is higher than its legal value as coin.

III. * Gresham's Law—its limitations.

(1) *Good money as well as bad money will remain in the circulation, so long as the good and the bad money, taken to-*

* In view of these limitations, Prof. Kinley puts the law in this comprehensive form, "If more than one form of money is legally usable

gether, are not in excess of the monetary needs of the community. In such a case good money will not be driven from the circulation.

If the total stock of good money and bad money be insufficient for the needs of the community, then owing to the great demand for money even the good money will have a greater value in its coined form than as metal. So it will not be profitable to withdraw good money from the circulation and it will remain in the currency circulation.

(2) *Again bad money and not good money will be driven from the circulation, when bad money is refused by the public, on account of custom or public opinion.* If in a country, people refuse to accept inconvertible paper (bad money) because it is very bad and very much depreciated in value and if they want gold, inconvertible paper (bad money) will be driven from the circulation.

* When the people of a civilized country are forced by war or other emergencies to a regime of inconvertible paper money, they will try to get back to good money and to withdraw the bad money as soon as possible after the emergency is over. After a period of inconvertible paper money from 1914

in a country, and if one of these is more valuable for some other use than it is for making exchange, then the inferior portion of the currency will supplant the superior to the extent that the two portions together exceed the need for currency in the country provided that public opinion or any other economic force does not interfere with the operation of the self-interest of dealers in money."

According to Prof. Marshall, "*Gresham's Law has been considered generally in relation to metallic currencies: it represents a tendency to take good coins out of the currency*" and "*Gresham's Law is that an inferior currency, if not limited in amount, will drive out the superior currency.*"

Gresham's law is really a limited statement of a more general principle. In a community in which competition is free and intelligent, there is a constant effort to perform every economic service by the agency which yields the largest net results.

* "I believe I shocked some people a little time ago by saying that it was false in the long run that 'bad money drives out good', but I was perfectly right. Good money does in the end overcome bad, even when the bad is numbered by trillions"—Cannan, *An Economist's Protest*, 1927, page 391.

to 1925, England restored the gold standard in 1925: so also certain other countries.

Gresham's Law in Europe during and after the War.

During and after the War many European countries with a gold and silver currency issued enormous quantities of inconvertible paper which greatly depreciated in value. According to Gresham's Law, the depreciated inconvertible paper money (bad money) has driven the good gold and silver money out of the circulation—and many countries of Europe have had almost entirely paper money of varying degrees of worthlessness.

As regards the disappearance of gold from circulation in England during and after the War, and the replacement of gold by treasury notes (practically inconvertible notes issued by the British Government), some maintain that this is also an instance of the operation of Gresham's Law; and other writers maintain that this is not a true instance of bad money driving out good money because the withdrawal of gold from the circulation in England was carried out by banks as a deliberate policy for increasing the Reserve of the Bank of England. (Under the Defence of the Realm regulations, it was made a criminal offence to melt down gold coins in England or to export them to foreign countries. So paper money became practically inconvertible in England, and the banks were free to withdraw gold coins from the circulation.)

Gresham's Law in India.

The operation of Gresham's Law is found in the Indian Currency. The gold sovereign is *good money*, it has a face (coin) value equal to its metallic value, and as compared with the sovereign, the silver rupee is *bad money*, it has a face value in normal times higher than its intrinsic value—and the bad money (the rupee) has a tendency to drive out the good money (the sovereign). The sovereign disappears (i) by exportation abroad when India has a balance of debt to pay to foreign countries, (ii) by melting for ornaments and industrial uses, (iii) and largely by hoarding. The rupee is not exported because the foreigner will not take it at its artificial high value; it is not melted for that would be a loss to the melter; and when an Indian of means hoards he prefers gold to silver, and the gold sovereign to the token rupee with its artificial high value.

Systems of Metallic Currency—

The Question of the Standard ; Monometallism (the Single Standard), Bimetallism (or the Double Standard), and the Gold-Exchange Standard.

There are different systems of metallic currency.

(A monetary system in which the principal or standard money is composed of one metal (gold or silver) is called monometallism. In pre-war England the standard money is composed of gold, and so England has gold monometallism. Pre-war China has silver monometallism.

***Different ways of combining gold and silver in the currency system of a country.**

In modern times two chief ways of combining gold and silver in the currency system of a country have been tried.

(1) In the nineteenth century, Britain since 1816, followed by the United States of America, Germany and other European countries, have maintained the *gold standard—gold as the standard of value with silver as subsidiary and token money.*

* In ancient times in Asia Minor, money was used made of electrum, a natural alloy of gold and silver.

Marshall's idea of *gold-and-silver symmetallism as the standard* has considerable theoretical interest, though not practically tried. "This suggestion is first found in his reply to the Commissioners of Trade Depression in 1886. He argued that ordinary bimetalism would always tend to work out as alternative-metallism. "I submit," he went on, "that if we are to have a great disturbance of our currency for the sake of bi-metallism, we ought to be sure that we get it . . . My alternative scheme is got from his (Ricardo's) simply by wedding a bar of silver of, say, 2000 grammes to a bar of gold of, say, 100 grammes; the government undertaking to be always ready to buy or sell a wedded pair of bars for a fixed amount of currency . . . This plan could be started by any nation without waiting for the concurrence of others." He did not urge the immediate adoption of this system, but put it forward as being at least preferable to bi-metallism. The same proposal was repeated in 1887 in his article on "Remedies for Fluctuations of General Prices," and in 1888 in his Evidence before the Gold and Silver Commission"—*Memorials of Alfred Marshall* edited by A. C. Pigou, 1925, pages 31-32.

(2) For several centuries, leading European countries had followed *bimetallism using both gold and silver as standards of value* before they established gold monometallism or the single gold standard.

(A monetary system in which the principal or standard money is composed of gold and also of silver is called bi-metal-
lism. It is essential to a complete

Bimetallism. bimetallic system that (a) *both metals* should be *unlimited legal tender* and (b) both should be *freely coined at a fixed ratio of exchange* between the two metals. In all modern countries where bimetallism has been tried, the two metals used have been gold and silver.

Under monometallism, only one metal forms the standard money and is the standard of value, only one metal is unlimited legal tender and only one metal is freely coined and is important in the circulation.

Under bimetallism, two metals form the standard money and are the standards of value and two metals are freely coined and are unlimited legal tender and are important in the circulation.

Limping Bimetallism—the Etalon Boiteux.

A monetary system in which two metals are unlimited legal tender and are important in the circulation, but only one has got free coinage—such a monetary system is called Limping Bimetallism or imperfect Bimetallism. France had gold and silver coins as unlimited legal tender but only gold coins had free coinage. France had therefore the Limping Standard.

Decline of Bimetallism.

Bimetallism has been tried in the United States, also in Europe. It was practised in France and in the countries of the Latin Monetary Union from the end of the eighteenth century till 1873. The Latin Monetary Union included France, Italy, Greece, Belgium and Switzerland.

Triumph of Gold Monometallism in pre-war Europe.

For sometime the tendency of monetary evolution has been in the direction of gold monometallism. Bimetallism is

displaced—and also silver monometallism. The system of gold monometallism has been established in England in 1816, Germany in 1873, Austria in 1892, Russia in 1897, and in Japan in 1897 and in the United States in 1900.

The displacement of silver is an important chapter of monetary history. For hundreds of years silver had been freely coined and had been the more important money metal of the world ; and it was deposed and discarded from its pride of place in the brief course of one generation.

Germany after her triumphant success in the Franco-German War adopted the Gold Standard in 1871-1873. And Germany was followed by the Scandinavian monetary union in 1873. So the demand for silver for currency purposes was substantially reduced, and at the same time there was a large increase in the supply of silver from the American silver mines (the Comstock lode). The result was a heavy fall in the price of silver. The Latin Union had free coinage of silver; and it was now flooded with silver and threatened with a loss of its gold—and so in 1878 it stopped the free coinage of silver. "To all intents the Latin Union has been on a gold basis since 1878, because although the silver five-franc coins are still full legal tender, there is no free coinage."

The United States is a great silver-producing country. And during the last quarter of the nineteenth century it made great efforts to check the fall in the price of silver—partly in the interests of the silver-producers and partly because of the agitation of the farmers who attributed the fall in the price of wheat to the competition in the silver-standard countries. The Bland-Allison Act of 1878 provided for the monthly purchase by the government at the market price not less than two nor more than four million dollars of silver bullion and to coin it into the standard silver dollars, which were made legal tender. The Sherman Act of 1890 repealed the Act of 1878 and arranged for the monthly purchase by the government of four and a half million ounces of silver at the market price. Within a few years the large accumulation of silver drove out the gold and threatened the stability of the gold reserve. And when in 1893 India stopped the free coinage of silver, the United States had to repeal immediately the Sherman Act and finally abandoned the efforts "to create an artificial market for silver as a stepping-stone to bi-metallism." India adopted the gold standard (the Gold-exchange standard) in 1899 and in 1900 the gold standard was established in the United States.

Restoration of the Gold Standard in Britain and in many countries after the War.

The triumph of gold monometallism was interrupted temporarily at least by the last great European War which overthrew the gold standard in all the big pre-war gold-

standard countries including even Britain and excluding the United States of America. The gold standard was restored in Britain and in many countries after the War.

The Question of the Standard.

What are the things which do—which should—influence a country in deciding whether it should adopt Bimetallism, Monometallism or any other kind of standard? Economic writers, most of them, are agreed that *a country should select that standard which will enable it (1) to have a stable internal value of money (and stability of prices within the country) promoting the smooth course of consumption, production and exchange, (2) to have a stable external value of its money, i.e., stability of exchanges with foreign countries maintaining and developing its foreign trade.* Economy is desirable—but not at the cost of efficiency. Simplicity of working, if possible, is an additional attraction. Also the system should not be too refined or theoretical for the people at large. Then it would inspire confidence—and the people's confidence is essential to the successful working of the monetary system.

1. BIMETALLISM (The Double Standard.)

The Arguments usually urged in favour of Bimetallism.

Bimetallism is no longer an active force. The agitation for bimetallism is now a thing of the past, though in its time it was very urgent, insistent and wide-spread in character and powerfully supported by a strong body of scientific opinion.

The arguments of these advocates of bimetallism are noticed below.

- (1) The main requisite in a standard of value is that its value should be as far as possible stable (*i.e.* its purchasing power should be constant). Advocates of bimetallism maintain that *bimetallism secures a more stable standard of value and more stable prices than monometallism in the following ways:*
 - { Bimetallism provides a more stable standard of value than monometallism and lessens fluctuations of prices.)

* Bi-metallism is the only scheme for securing stability of the standard of value which has received any substantial measure of popular

(a) They say that when two metals are used the total stock of money is larger than only when one metal is used to form standard money ; and the total stock of money in bimetallism being larger, any addition to the quantity of money will affect the value of money and the price level in a smaller degree than under monometallism. (b)* It is also urged by the bimetallists that the increase or decrease in production of one metal will be often counteracted by the decrease or increase in the production of another metal ; and so the total result will be that the value of money will be steadier under bimetallism than under a monometallic system, and therefore general prices will be steadier under bimetallism. This argument has a certain amount of value.

Historically bimetallism in France in the period immediately after 1850 served to steady (i) the ratio between gold and silver, and (ii) the general level of prices. So far the bimetallists were justified. But since 1890, there had been a great increase in the supply of gold from the world's mines and the indications are that there would have been also a great increase in the supply of silver if bimetallism had been established with the free coinage of silver ; and so the establishment of bimetallism instead of steadying prices in fact would have made prices less stable than they are under monometallism.

(2) (*Bimetallism by a rise in prices benefits producers and encourages production*).

Some bimetallists maintain that under bimetallism the total

support. Other schemes with this object are at present only of academic interest—polymetallism (circulation of more than two metals), symmetallism (two or more metals joined physically together in the same coin or in linked bars), joint-metallism (a kind of Bimetallism at a fixed ratio), also Fisher's scheme of the compensated dollar and an artificial gold exchange standard. (Fisher—*The Purchasing Power of Money*, Chapter XII).

* The fact is that under certain exceptional conditions, even one metal may secure more steadiness than two metals. "Two variable metals joined through bimetallism may be linked to two tipsy men locking arms. Together they walk somewhat more steadily than apart, although if one happens to be much more sober than the other, his own gait may be made worse by the union." (Fisher—*The Purchasing Power of Money*, Chap. XIII).

money stock would be larger and would increase more rapidly than under monometallism; and thus (there will be a gradual depreciation in the value of money and rise in the prices of commodities under bimetallism which will stimulate the producers of commodities by increasing their profits.)

Owing to the demonetisation of silver and the abandonment of bimetallism by the Latin Union in 1873, prices fell and the fall in prices discouraged producers.

(3) *Bimetallism by a rise in prices (and a fall in the value of money) benefits debtors.*

According to some advocates of bimetallism, the bimetallic system brings about a gradual depreciation in the value of money and thus benefits the debtor class by reducing the burden of debt.

(4) Under a complete system of bimetallism in which both metals are unlimited legal tender for all payments, the banks would be able to keep and manage their reserves of metal more easily and economically and the rates for money would be lower and more uniform.

(5) Another very important claim made by the bimetallists is that bimetallism (helps the development of foreign trade by establishing a par of exchange between gold-using and silver-using countries.)

Now, two countries having the same metal as the standard of value, have a par of exchange between them in their international trade (exchange being said to be at par when a merchant paying a certain amount of money metal in his own country can purchase the right to get exactly the same amount of metal in a foreign country)

But between two countries one having silver as the standard of value and the other having gold as the standard of value, there is no fixed par of exchange—the relative value of gold and silver is not a fixed one but fluctuates according to the variations of demand or supply of the two metals.

If several nations accept bimetallism and establish a fixed

ratio between gold and silver by international agreement, a fixed par of exchange between them is established. There will be no large fall in the price of gold as compared with silver, or large fall in the price of silver as compared with gold, merchants will not suffer any losses in their foreign trade through fluctuations in the price of gold or silver and the risks of business being thus diminished, the commerce between gold-using and silver-using countries will be increased.

Some Arguments usually advanced against Bimetallism.

(1) ** Bimetallic countries have really one money and that the worse money.*

If a nation accepts bimetallism, then under the operation of Gresham's Law the country will be left with the bad money (*i.e.* money overvalued in the circulation and having a higher value as coin than as uncoined metal) and the other metal will go out of circulation.)

(Prof. Marshall urges the following important considerations). If the use of gold in the arts increases, the value of gold will rise; and if in the currency a fixed ratio between gold and silver is established, then the market ratio between gold and silver will differ from the monetary ratio. There will be *speculation* as a consequence of this, and its attendant evils).

(2) Opponents of bimetallism declare that when the legal ratio between the two metals in the currency will differ from

* Some historical examples of this are given below.

Currency History of France.

In Europe, many countries adopted gold monometallism by the year 1873; and in the countries of the bimetallic league called the

Silver threatening to displace gold.

Latin Union, silver being overvalued in the circulation, under the operation of Gresham's law gold began to disappear from these countries and flowed into the gold mono-

metallic countries. The countries of the Latin Union were threatened with the danger of being left with one money (silver money) and that

composed of the metal having a higher value as coin than as bullion. (2) During the rule of the third Napoleon in France, the silver money being undervalued in comparison with gold in the currency, gold (bad money because overvalued in the currency) began to displace silver from the circulation.

the market ratio, *creditors will want payment in the dearer metal and debtors will want to pay in the depreciated metal.* A great deal of confusion will be the result of all these.

Is Bimetallism practicable?

In addition to the arguments already advanced in favour of bimetallism (see pages 67, 70), the bimetallists maintain that the bimetallic system is quite practicable. They maintain that this is shown by the experience of the Latin Monetary Union which successfully maintained a bimetallic system from the end of the 18th century to 1873.

At the time of the establishment of bimetallism, the legal ratio between the two metals in the currency should be the same as the market ratio between the two metals in the market for metals; and if this be done, then the legal ratio can be maintained under certain circumstances.

If only one country accepts bimetallism, then the ratio will not be maintained and bimetallism will collapse. As soon as the value of one of the metals rises or falls in the market owing to the fluctuations of demand and supply, the market ratio between the two metals comes to differ from the legal ratio and under the operation of Gresham's law the good money (*i.e.* the money made of the metal which has a higher value as metal than as coin) will be exported to foreign countries and the country will be left with *only one money* (bad money made of the depreciated metal).

But if many countries accept bimetallism with a fixed ratio between gold and silver, then the operation of Gresham's law can be counteracted and bimetallism can be maintained at the legal ratio fixed upon by the governments.

(Suppose the governments of several nations establish bimetallism at the ratio of 15 to 1 (1 oz. of gold in coins = 15 oz. of silver in coins), that being also the market ratio at the time. Then after a time the value of one of the metals, *viz.* silver falls in the market—1 oz. of gold bullion becomes equal to 16 oz. of silver bullion. The value of silver being now higher in the form of coins than as bullion, people will find it

profitable to coin silver bullion into silver coins; debtors will now want to make their payments by coining the depreciated metal (i.e. silver) and in this way there will be an increased demand for the depreciated metal and the increased demand for the metal will check the depreciation of its value. Payments will be made now in silver, and so there will be less demand for gold, and the price of gold will fall. In this way, by a rise in the price of depreciated silver and by a fall in the price of gold, the ratio between gold and silver metal will tend to be brought back to the legal ratio between gold and silver in the currency (1 oz. gold in coins = 15 oz. of silver in coins). This is called the compensatory action of bimetallism.

The larger the number of countries accepting bimetallism at the same fixed ratio, and the greater the economic resources of these countries, the stronger will be this compensatory action.

It thus appears that *national bimetallism* (bimetallism established in one country independently of other countries) is impracticable; *international bimetallism* (bimetallism established at a fixed ratio by the joint agreement of several nations) is practicable.

Under what conditions is a Bimetallic System practicable?

The first condition is that it must be accepted at a fixed ratio by the joint agreement of several industrially and commercially powerful nations. *With bimetallism universal or general among nations, the ratio might be maintained.*

But as many economists point out there would be great difficulty as regards securing an international agreement for the purpose of bimetallism. "Each country makes it a point of honour to adopt a gold standard. The English Government, in particular, whose aid would be indispensable in re-establishing bimetallism, has always set its face against it."

And at present there is no immediate prospect of such international agreement for establishing bimetallism.

International Bimetallism.

Advantages.

(1) International bimetallism has all the advantages described on pages 67, 70 in a fuller measure and over a much wider area than national bimetallism.

(2) International bimetallism *secures a par of exchange between gold-using and silver-using countries* which national bimetallism does not.

(3) It has been already seen that *international bimetallism is practicable* and can be maintained; but this is not the case with national bimetallism.

Obstacles to International Bimetallism.

The following are some of the difficulties which, in the past, have stood in the way of the establishment of bimetallism by an international agreement among nations.

(1) Nations think that the system of gold monometallism increases national prestige, and this makes them opposed to bimetallism.

(2) Different countries have now got different ratios of coinage between gold and silver; and it would be difficult to change these different ratios into one common ratio for all countries.

Difficulty of establishing a common ratio.

(3) England is a great creditor nation; and under her gold monometallic system the interest to be paid to her for the money lent by her to other nations is due in gold. If international bimetallism is introduced, England fears that the interest may be paid to her in depreciated silver money; in that way she might incur large losses. The opposition led by England against international bimetallism is one of the chief causes of the non-acceptance of bimetallism by nations.

(1) Banks would refuse to make future contracts in terms of silver as they expect 'depreciation of silver.' They would hoard gold and the Governments also do the same to a certain extent. The bimetallic system would thus break down.

Banks opposed to international bimetallic schemes.

Decline in the Bimetallist agitation brought about by an increased production of gold.

The demand for bimetallism has in a great measure diminished. A large body of people wanted bimetallism on

the ground that it would bring about an increase in the volume of the currency and a fall in the value of money ; and they have had their desire satisfied by the increased production of gold in pre-war years of the nineteenth century.

Prof. Marshall says in his *Money, Credit and Commerce* "The advantages of basing the currencies of the world on two metals rather than one seem to be estimated by careful thinkers *now* at a lower value than formerly."

Bimetallism is no longer a question of general public interest ; though there are in Europe and America some economists* who believe that international bimetallism is *practicable and desirable*.

International Monetary Conferences.

Many distinguished theoretical economists and also some practical statesmen have favoured the idea of bimetallism on an international scale. The movement has always received the powerful support of the United States. The opposition of England, the apprehensions of the business world and other practical difficulties have been strong enough to prevent the establishment of a bi-metallic agreement among nations. The two important monetary conferences, the Paris Conference of 1878 and the Brussels Conference of 1892 did not succeed in bringing about any international agreement about bimetallism.

International monetary conferences have failed to establish international bimetallism.

In recent years, Prof. Gustav Cassel, an eminent Swedish economist, has expressed the opinion that there is going to be a shortage in the world's production of gold in future ; and this has once more revived interest in schemes of bimetallism.

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Bi-metallism and the World Economic Depression.

The world economic depression has brought about a heavy fall in the prices of agricultural products, minerals and manufactures in all countries, has caused the gravest hardships to producers, labourers, traders and governments. The price level of commodities has to be raised to remedy the existing intolerable situation. A most important cause of this world

economic depression is that the United States and France have secured the greater part of the world's gold supply leaving less than their due share of gold in other countries of the world, and thus bringing about falling prices in these other countries. On account of the closeness of the international economic relations now-a-days, the United States and France also have not escaped falling prices and their damaging effects. Some have suggested that the adoption of international bimetalism by leading countries will base the world supply of purchasing power on two metals, gold and silver (instead of gold only), and will thus make available the increased supply of purchasing required to raise the world's price level. The world badly requires a rise in the price level at present.

* But this talk of the revival of bimetalism is not finding influential support. International bimetalism, if adopted by all leading countries, will be practicable. But the prejudice against silver in France, Britain and other leading countries is strong, so international bimetalism is not going to be established. Important countries—Britain and others—are rather thinking of the restoration of the gold standard (if not in the immediate future and) with greater economy of gold and closer co-operation between the Central Banks of the different countries.

II. MONOMETALLISM.

(The Single Standard)

All important modern countries (except China) following Monometallism follow the gold standard. (But half the world is *now* on the paper standard).

Arguments against Monometallism.

The arguments used in favour of bimetalism tend to show the superiority of bimetalism over monometallism—these arguments are obviously arguments against monometallism. (See pages 67-70).

* Refer to the Draft Annotated Agenda submitted by the Preparatory Commission of Experts in connection with the World Monetary and Economic Conference, pp. 17-18.

*** The case for Gold Monometallism—the arguments in favour of Gold Monometallism.**

As has been already indicated, the agitation in favour of bimetallism weakened greatly on account of the increased production of gold. Bimetallic schemes have been rejected by international monetary conferences. The principal arguments generally advanced in favour of gold monometallism are the following :

(1). Gold monometallism is simpler than bimetallism and so more easily worked in practice.

(2) Gold being the dearer metal is more serviceable as currency to the rich and economically progressive communities in Britain, the United States, etc., with their comparatively large scale of incomes and transactions.

(3) The most important thing in a monetary standard is stability—the monetary standard should secure stability of domestic prices and stability in international exchanges. And advocates of gold monometallism maintain that gold monometallism is expected to maintain this stability better than any other proposed system.

* Various theoretical standards have been proposed for securing stability of the value of money better than is done by the gold standard (see *Proposed Monetary Reforms*, pages These may be suitable when peoples and governments are more civilised. *With peoples and governments as they are at present the Gold Standard is the best available instrument.*

"The Gold Standard has been rightly described as an expedient fit only for a barbarous age. But can any one who has lived through the Great War have any doubt that a barbarous age is precisely what we have for the moment to provide for? *The cruder and simpler principle may suit us best for the present and immediate future*" (Cannan—*Economic Journal*, June, 1924, p. 161).

"With all its shortcomings, the gold standard seems to be the one which involves the least injustice" (Seligman—*Principles*).

"The best check to irregular fluctuations in the volume of 'money' and also the irregular fluctuations in the use of the credit substitutes for money, is that all shall rest securely on gold the world over. So long as this is the case, there will be neither very wide changes in prices in the course of any one generation nor very abrupt fluctuations at any time or in any country. It is not a perfect arrangement; but it is the best workable one that is available" (Taussig—*Principles*, Vol. I chapter 31).

Gold provides for stability of prices by limiting the volume of currency by physical causes.

Again the progress of industrial invention gives us grounds for believing that the supply of gold from the mines, (with economising of gold by central banks and international co-operation) will be equal to the demand for gold under the system of monometallism.

For the recent break-down of the Gold Standard in many countries on account of the lack of international co-operation, refer to pages 81, 82, 86, 87.

Two important types of the Gold Standard—

(1) The Gold Standard with a Gold Currency and (2) the Gold Bullion Standard.

The pre-war type of the gold standard is the gold standard with a substantial quantity of gold coins in circulation (in addition to paper money). This kind of the gold standard is known as the gold circulation system. Gold is the standard of value for measuring the values of commodities and services in the country. Notes are valued in terms of gold, are convertible into gold coins; whether these gold coins are required for internal use or for export. (Before 1914, Britain had this kind of the gold standard, also the U. S. A., France, Germany and other leading countries.

The post-war type of the gold standard is the Gold Bullion Standard. In this kind of the gold standard the monetary circulation consists largely of paper money (as in England after 1925) or largely of paper and silver (as was suggested for India by the Indian Currency Commission of 1926)—there is little or no gold in circulation. Gold is the standard of value. For the paper representative of the monetary unit (pound sterling note or rupee note) has a fixed gold value, and at this fixed gold value notes are convertible into gold bar or gold bullion (not into gold coins) whether the gold is required for internal purposes or for export. As the Macmillan Report puts it "The gold price of the paper representatives of gold is determined by the limits at which the Central Banks will give gold for paper or paper for gold". (The Gold Bullion Standard requires a gold reserve to maintain the gold value of the monetary unit.

The supporters of the Gold Bullion Standard point out that

this type of the gold standard is a *true gold standard* maintaining the value of the monetary unit at a fixed gold value—at the same time the Gold Bullion Standard avoiding the circulation of gold is *more economical* than the old type of the gold standard with a gold currency, also *more scientific* in certain other ways; and because of the economy of gold, the Gold Bullion Standard is *more suited* to the impoverished nations after the World-War.

**Britain introduces the Gold Bullion Standard in 1925.
The Gold Bullion Standard proposed for India in 1926.**

During the War (1914—1918), and for some years after Britain circulated vast quantities of inconvertible paper money, was on the inconvertible paper standard, did not maintain the gold standard. In 1925, Britain succeeded in restoring the gold standard in the form of a gold bullion standard. By the Gold Standard Act of 1925, the Bank of England "is obliged by the law to sell gold bullion to any one who pays for it in legal tender (which in this case means bank-notes), at £3 17s. 10½d. per ounce standard, but only in bars containing approximately 400 fine ounces. Free convertibility of the bank-note for those who want gold for export is thus secured, and the golden link is firmly riveted between the English pound and the currencies of other countries that are on the gold standard, or are more or less closely hitched to it. This golden link between the currencies of the chief countries of the world is of immense benefit to international trade, by keeping fluctuations in rates of exchange within moderate limits"—Hartley Withers, *The Meaning of Money*, 1930, pages 25—26.

The Indian Currency Commission of 1926 recommended that India should abandon the gold exchange standard and should introduce a gold bullion standard.

The essentials of the Gold Standard.

The essentials of the pre-war Gold Standard—the Gold Standard with a circulation of gold coins—have been already indicated. To quote the Report of the Gold Delegation of the Financial Committee of the League of Nations "The

normal features of the gold standard in its simplest form would be the acceptance of gold without limits by Governments at a fixed price for minting into coin, the free circulation of gold coin as full legal tender and the unrestricted import and export of gold".

The essentials of the post-war Gold Standard—the Gold Bullion Standard (without a circulation of gold coins)—have been also described.

In both forms of the Gold Standard one thing is common without which a true Gold Standard cannot exist—the *value of the monetary unit of the country has an approximately fixed value in terms of gold*; the value of the monetary unit and the value of a fixed weight of gold are kept equal to each other. This is what makes it a true Gold Standard.*

III. The Gold Exchange Standard.

In certain countries before the World-War, and after the failure to secure any international agreement about bimetallism, the gold exchange standard was evolved as a new method of approaching the problem of stable exchanges between gold and silver countries—between countries using gold like Britain and the United States and countries using silver like India, Mexico, Panama and the Philippines.

If in the monetary system of a country we have (1) coins of two metals as unlimited legal tender, (2) the use of a local currency mainly not of gold in the internal circulation, and some degree of unwillingness to supply gold (international currency) for internal circulation in exchange for the local currency, (3) a high degree of willingness to give international currency in exchange for local currency at a certain maximum rate for making payments to foreign countries and the use of a reserve of the superior metal and other foreign credits for this purpose, then such a system is called a Gold Exchange Standard.

(The gold-exchange standard was first introduced into Java

* "The phrase "a gold standard will be used to denote a state of affairs in which a country keeps the value of its monetary unit and the value of a defined weight of gold at an equality with one another."—Robertson, *Money*, 1930, Chap. IV, page 64.

and it has worked in India, the Philippines, Mexico and Panama.)

(In the pre-war period and roughly between 1899 and 1917, India had a gold exchange standard*—she used an inferior metal (silver) for the local currency and made gold (international currency) available for foreign payments, at a certain maximum rate in exchange for local currency; and India had a reserve (consisting largely of foreign credits in Britain) called the Gold Standard Reserve for maintaining the Gold Exchange Standard.)

The Indian gold exchange standard had an internal currency chiefly of rupees, and it made gold available for foreign payments in exchange for rupees—and so it is called a *compromise standard*, a compromise between the silver and the gold standard.

Recent abandonment of the Gold Standard by Britain and many other countries. The Sterling Standard in Britain and the Sterling Exchange Standard in India to-day.

Over the greater part of the world, the gold standard has ceased to function due to the world economic depression and certain connected causes. (For the causes, refer to pages 86-87).

In September 1931, Britain was compelled to abandon the gold standard. Before the end of October, all the British Dominions excepting South Africa, the rest of the British Empire, and the three Scandinavian countries, as well as

* Mr. Robertson makes the following observations in connection with the gold exchange standard:

"..... an interesting group of countries which before the war included India, and still contains a number of countries (such as the Philippines) with a political status similar to hers. In these countries (1) the standard money is token money, (2) but is nevertheless regulated by Government in a manner which is not arbitrary, but is designed to keep the value of the standard money stable in terms either of some other country's money or of gold.

Under this system, then the quantity of standard money is regulated by Government not arbitrarily, but with reference to the world value of gold: and the value of the money of such a "gold exchange standard" country tends, like the value of the money of a gold standard country, to equal the marginal cost of production of a given weight of gold."

Portugal, Egypt, Bolivia and Finland had departed from gold. Japan followed in December 1931, Greece in April 1932, Siam and Peru in May 1932.

Britain is now on a paper standard, the standard of value being the paper pound (the paper note) not convertible into gold—it is said to be on the sterling standard, the paper pound sterling (not the gold pound sterling) being the standard of value now in England. India and other parts of the British Empire (excluding South Africa) are now on the sterling standard, the value of the monetary unit in each of these countries being kept at an approximately fixed value in relation to sterling. In India the rupee is being maintained at an approximately fixed value of rs. 6d. sterling. India at present has not a gold standard, the monetary unit (the Indian rupee) having no fixed value in relation to gold and being not convertible into gold. India has now no gold exchange standard, the Indian rupee being not convertible into gold at a fixed value even for foreign payments. India has only a sterling exchange standard—the Indian rupee being convertible for foreign payments at a fixed value only into sterling or the paper pound (paper money) of England.

The Proposed Sterling Bloc.

It has been suggested that Britain, India and other countries of the British Empire, also certain other countries outside the Empire including the Scandinavian States may form a sterling bloc. The British Empire is on the sterling standard and the currency of the countries outside the Empire willing to join the sterling group may be so regulated as to remain at a certain parity with sterling. Prof. Gustav Cassel in his memorandum of dissent relating to the Report of the Gold Delegation of the League of Nations maintains "within such a "Sterling Group", it would be possible to develop a sound international trade of some stability".

Prof. Gregory examines the case for a currency union upon a paper basis and is not highly impressed—Gregory, *The Gold Standard and its Future*, 1932, pages 86–89.

As regards the countries which have been forced recently

to abandon the gold standard, Prof. Gustav Cassel thinks
 "several years must elapse before a restoration of an international gold standard system can be seriously contemplated

It is an open question whether it will be possible in the future to restore the gold standard as an international monetary system. It is quite possible that the difficulties will prove insuperable, and that the paper-standard system will attain such a stability as to become generally acceptable".

The International Gold Standard before its recent abandonment.

"To restore gold to its old position as an international standard of value was the avowed aim of currency policy for a period of six or seven years after the cessation of hostilities. This aim was endorsed by two International Conferences, that of Brussels (1920) and Genoa (1922).

By an international gold standard is to be understood not identity of the currency arrangements of all the countries comprising the gold standard group but the possession by all of them of one attribute in common, namely that the monetary unit (i.e. pound sterling, dollar, franc, mark and so on) should possess a gold value prescribed by law, or, rather, a gold value within the limits of the buying and selling price of gold of the local Central Bank. In almost all countries gold coin has now been withdrawn from circulation and its place taken by paper representatives of the gold. The gold price of the paper representatives of gold is determined by the limits at which the Central Banks will give gold for paper, or paper for gold.

The legal determination by each of a group of countries of the gold equivalent of the monetary unit, though an essential, is not the only condition of an effective international gold standard. Something more is necessary; namely, the right freely to import gold and to tender it in unlimited quantities to the Central Bank; and the converse right, freely and in unlimited quantities, to draw gold from the Central Bank and to export the gold so obtained

Primary objective of the Gold Standard.

The primary object of the international gold standard is to maintain a parity of the foreign exchanges within narrow limits; this has the effect of securing a certain measure of correspondence in the levels of prices ruling all over the gold standard area

The fact that a state of temporary disequilibrium can be adjusted.

by flows of gold or foreign exchange does not remove from the currency authority the necessity of caution and of interpreting the situation in the light of its fundamental duty of safeguarding the national standard The ultimate aim—the restoration of the international value of the currency—is clear, but the action to be taken, and the precise moment at which it should be taken, remain in the sphere of discretion and judgment, in a word with “management.” The sense in which the gold standard can be said to be automatic is thus very limited; it is automatic only as an indicator of the need for action and of the end to be achieved.

Secondary objectives of the Gold Standard.

It may be considered a secondary object of the international gold standard to preserve a reasonable stability of international prices. The mere existence of an effective international gold standard does not, however, guarantee stability of prices as a whole either over space or over time

Conditions necessary for the working of Gold Standard.

The international gold standard is intended to subserve the general idea of stability—as regards the relations between currencies, and price relationship over space and time—but it does not, in and of itself, guarantee that this ideal will be realised. The international gold standard can, under appropriate conditions, enable both exchange stability and considerable degree of price stability to be attained simultaneously, over a wide area, but, the mere fact that the standard is gold, and that it is international, will not under all conceivable conditions and varieties of policy, automatically bring about these results. In other words, there are “rules of the game”, which if not observed, will make the standard work with undesirable, rather than beneficial, consequences.

It is difficult to define in precise terms what is implied by the “rules of the game.” The management of an international standard is an art and not a science, We consider that the following principles would be generally accepted:—

- (i) The international gold standard system involves a common agreement as to the ends for which it exists.
- (ii) It should be an object of policy to secure that the international gold standard should bring with it stability of prices as well as that it should guarantee stability of exchange.
- (iii) Action by individual Central Banks which, by repercussions on the policy of the others, imperils the stability of the price level should, as far as possible, be avoided”—*The Macmillan Report*, Part I. Chap. III. pp. 18-24.

Important changes in the Gold Standard before its breakdown.

"The more important changes which were effected before the recent breakdown of the system over large areas of the world may be enumerated as follows :—

(a) In most countries gold coin had been effectively withdrawn from circulation, and monetary gold had been concentrated largely in the vaults of Central Banks.

(b) For the obligation of Central Banks to convert their notes into gold coin, there was substituted in most countries an obligation to convert them into either (i) gold bullion, or (ii) foreign gold exchange, or (iii) either the one or the other at their option.

(c) Banks empowered to convert their notes into sight claims on gold were allowed by the new banking laws to keep the whole or a part of their reserve in the form of such claims. There is no necessary connection between these two provisions. Some Central Banks which were obliged to redeem their notes in gold have the right to keep part of their reserves in foreign exchange.

(d) In consequence, banks enjoying this alternative were in the habit of holding in their reserves gold exchange on certain international monetary centres, principally New York and London, which collectively have amounted to very considerable sums.

(e) In most cases, whether such foreign gold exchange was allowed to constitute a part of the gold reserves or not, the total reserves required by the new legislation were expressed as a definite percentage of total notes outstanding or notes plus Central Bank sight liabilities. Although this *percentage reserve system* is by no means new, it became, in recent years, more generally adopted than before the war, and frequently in a more rigid form.

In addition to these changes, which resulted directly or indirectly from the new legislation introduced, the functioning of the gold standard was affected by certain changes in bank practice and in general financial conditions—such, for instance, as the development of open-market operations, more especially in London and New York, the growth of New York as a major lending centre and narrowing of the gold points in certain cases.

The result of the collection of gold in Central Bank reserves and the withdrawal of gold coin from circulation was at once to effect an economy in its use and to increase the potential influences of any gold movement. Under this system, all accessions of gold may be made to exercise a maximum influence on the total volume of currency, for they inevitably accrue to the foundations of the whole credit structure—the reserves of banks of issue. At the same time, the power of Central Banks to influence the situation was enhanced, as they were no longer subject to the risk that gold might be absorbed into the

internal circulation, though it has been withdrawn recently during periods of panic in the form of bullion for hoarding."—*Report of the Gold Delegation of the Financial Committee of the League of Nations*, p. 13.

The causes of the breakdown of the International Gold Standard.

"The way in which the Gold Delegation presents the causes of the breakdown of the gold standard seems to me entirely unacceptable. What we have to explain is essentially a monetary phenomenon, and the explanation must therefore essentially be of a monetary character. An enumeration of a series of economic disturbances and maladjustments which existed before 1929 is no explanation of the breakdown of the gold standard. In fact, in spite of existing economic difficulties, the world enjoyed up to 1929 a remarkable progress

It may be desirable that I should, on this occasion, very briefly summarise my views.

It had been made clear during the course of the last decade that the gold standard could be maintained only by the aid of a systematic gold-economising policy aiming at such a restriction of the monetary demand for gold as would prevent a rise in the value of that metal. To a certain extent, this programme had been carried out with the most beneficent result. From 1928 onwards, however, this policy was completely frustrated by extraordinary demands for gold which brought about a rise in the value of gold of unparalleled violence. The fundamental cause was the claim of reparations and war debts, combined with the unwillingness of the receiving countries to receive payment in the natural form of goods and services. This underlying cause became effective when France, in 1928, entered the gold-standard system and began to draw gold to herself on a large scale, and when, at the same time, America ceased that export of capital which previously had served to maintain equilibrium in her balance of payments. The consequence was such a drain on the gold reserves of other countries as to cause the breakdown of the international gold-standard system."—Professor Gustav Cassel's *Memorandum of Dissent*, p. 74.

Paper money.

Paper money has been used from very early times to replace a part of the metallic money for carrying on the exchange transactions of the community.

The history of paper money in Europe begins much later than its history in Asia.

In China it was used in the ninth century and possibly

even earlier than that. Japan and Persia introduced paper money perhaps in imitation of the Chinese. And there is some reason for believing that it was in circulation even in ancient Assyria and Babylon.

The enormous quantities of paper money issued by modern governments during the last Great War make this subject one of great interest and importance. During the War (1914—1918) and for some years after, Britain, Germany, France and other leading countries (practically with the important exception of the United States and some other countries) could not maintain the gold standard, circulated vast quantities of inconvertible paper money and were on the paper standard.

Britain and certain other countries restored the gold standard in the post-war period. But in the post-war period, under the post-war form of the gold standard (the gold bullion standard) gold has been withdrawn from circulation and concentrated in the reserves of Central Banks—and in all civilized countries the monetary circulation has consisted chiefly of paper money.

Since September 1931 and after, this restored gold standard (or the gold bullion standard) has been abandoned by a large part of mankind; and many important countries including more than half the world, Britain, British Colonies and India, the three Scandinavian countries, Japan, U. S. A. etc. are now on the paper standard and with the monetary circulation consisting practically of paper money.

These facts emphasise the vastly increased importance of paper money in recent times.

Paper money is the best money under ideal conditions—but often the worst money under actual conditions because of over-issue.

Paper money is both the best and the worst money—paper money is the ideal money of economic theorists under *ideal conditions* of regulation (refer to pages 99, 100), *actually* paper money has often proved the worst kind of money being enormously over-issued by governments and Central Banks

during war and other emergency and suffering enormous depreciation.

Three kinds of paper money.

^ There are three kinds of paper money.

(1) Representative paper money. The person or the institution issuing a representative paper money keeps a *reserve of metal exactly equal to the nominal value of the notes issued*. Representative paper money represents an equivalent amount of metallic money deposited somewhere. This kind of paper money is as safe as metallic money because it represents an equal amount of metallic money ; and it is at the same time more convenient and economical. Representative paper money may be issued by governments or by banks.

The gold and silver certificates of America are examples of representative paper money.

(2) Convertible, redeemable or fiduciary paper money. *This consists of notes for which specie can be had on demand*. It takes the form of a promise to pay a certain sum of metallic money.

As all the note-holders do not desire to convert the notes into metal at the same time, so *the amount of metal* to be kept as a reserve for securing the convertibility of the notes *is generally much smaller than the face value of the notes issued*.

(3) Inconvertible or irredeemable or conventional paper money.

This consists of notes for which specie cannot be obtained on demand.

The pieces of paper money of this description contain a printed statement that the notes are of such and such value (a note for 100 roubles, a note for 500 roubles) ; but they are not intended to be paid in metallic money.

Inconvertible paper consisting of notes issued by a government without the intention of paying it in specie is called fiat

There are two kinds of inconvertible paper money: (1) paper which is inconvertible from the time of its issue; (2) paper which was convertible when it was first issued, but which has ceased to be convertible on account of the subsequent insolvency of the issuers. "No paper money is convertible, the full, immediate and unconditional redemption of which is not at all times within the choice of the holder."

Some noted historical examples of irredeemable paper are the French *assignats* of the revolutionary period, the Bank of England notes during the period of restriction and the *greenbacks* issued by the American Government during the Civil War; and recent prominent examples of inconvertible paper are the German paper money (German *mark* notes) and the Russian paper money (Russian *rouble* notes) during and after the last World War.

Immense quantities of the paper money issued during the last World War are practically inconvertible and are attended with the evils of inconvertibility.

Is irredeemable paper properly called money?

(I) Many American economists have refused to give the title money to irredeemable paper chiefly perhaps because they regard the use of inconvertible paper as injurious to society. (II) Walker, on the other hand, maintains that what does the money work is the money thing. He declares that inconvertible paper does the money work (1) by serving as the common medium of exchange, (2) by serving as the value denominator, (3) by serving as the standard of deferred payments; and he concludes that inconvertible paper should therefore be regarded as money. It may perform the money functions badly under certain circumstances; and so it may be bad money but it is money.

Whether the creation of paper money is equivalent to the creation of wealth.

I. The view that the creation of paper money creates wealth.

Formerly it used to be believed that the creation of paper money was equivalent to the creation of wealth. It was held that the total wealth of a country was increased by the amount of paper money is wealth.

money that was created. The fallacy of this idea has now been clearly exposed and it is no longer believed in.

II. The modern view is different.

Suppose a country has got ten millions of ounces of gold in the currency. If it can replace even five millions of ounces

Paper money increases the wealth of a country to the extent it replaces metallic money.

of gold by an equivalent amount of paper money, it can employ this gold to purchase commodities from abroad or for investment in agricultural or manufacturing industries at home. Paper money will thus liberate five million ounces of gold for productive purposes and will make the country richer by five millions of ounces of gold.

Thus paper money increases the wealth of a country to the extent it allows the quantity of metallic money in the circulation to be replaced and no further.

* Advantages of paper money.

(I) If a country has got enough metallic money for all its wants, and if it then introduces a certain amount of paper money in circulation, the country will

The use of paper money is economical (a) for it saves Labour and Capital.

be benefited in the following way. Paper money will replace a part of the metallic money and this metallic money can be invested in domestic industries or used to purchase commodities abroad.

If all countries gave up the use of metallic money, then the labour and capital which are now used for mining the precious metals for monetary purposes, this labour and this capital can then be used for other productive objects.

* "The gold and silver money, which circulates in any country may be very properly compared to a highway, which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either. The judicious operations of banking, (in substituting paper money in the place of a great part of this gold and silver) by providing, if I may be allowed so violent a metaphor, a sort of waggon-way through the air, enable the country to convert, as it were, a great part of its highways into good pastures, and corn-fields and thereby to increase, very considerably, the annual produce of its land and labour (Adam Smith—*The Wealth of Nations*).

When the precious metals are used as means of exchange, there is a great loss through wear and tear of metals. There would be a large saving in this respect if paper is used as a means of making exchanges.

(II) Paper money is more convenient than metallic money for making large payments, and also payments in distant places.

It can be sent to a distance at less cost than metallic money, and the risk of loss is smaller.

These are the economic advantages of paper money.

(III) The advantage to the Government.

A government borrowing money has to pay interest on the loan. It may get money for its payment to its officers, contractors, etc., by issuing paper money ; and in this way it would save the interest which it would otherwise have to pay.

Disadvantages of paper money.

(1) *Paper money is national money*, circulating within the territory under the same government ; it has no intrinsic value, so it will not be accepted by foreign nations in their payments. Foreign nations will take metallic money which has intrinsic value ; metallic money is thus universal money.

(2) *Paper money is much less stable in value than metallic money.*

The quantity of paper money issued depends upon the caprice or the policy of a government, and so it is often issued in excessive quantities, and a great fall in its value is the result. There is a natural check to the supply of metallic money in its high cost and so excessive additions to the stock of metallic money, are not so easily possible as is possible in the case of paper money ; and therefore the value of metallic money fluctuates less than the value of paper.

Inconvertible paper (irredeemable paper) money.**(I) Advantages.**

The advantages which inconvertible paper possesses in common with convertible paper are given on pages 91, 92. Inconvertible paper has great advantages, if there be no overissue and under ideal conditions of regulation.

(II) Evils of irredeemable paper.

History shows that under actual conditions inconvertible paper has been always overissued by Governments and Central Banks in times of war and emergencies. Almost always there has been great overissue. Very serious evils have resulted.

- (1) Little or no reserve being required in a system of inconvertible paper, the danger of over-issue resulting in depreciation of value is greater in the case of inconvertible paper.
- Danger of overissue and depreciation.

And of course its value is much less stable than the value of gold money.

- (2) Under the operation of Gresham's Law, over-issue of inconvertible paper drives metallic money out of the circulation, the displaced metallic money being hoarded, melted or exported to foreign countries.
- Over-issue of inconvertible paper drives out metallic money.

(3) Great overissue of inconvertible paper brings about great rise in prices of commodities. Profits are unduly high. There is an excessive amount of speculation. Even incompetent producers with great rise in prices make excessive profits at the expense of labourers and consumers. There is inefficient work. Production is disorganised. Business becomes a gamble.

- (4) The wages paid in paper money do not rise as quickly and to the same extent as the prices of commodities; so labourers suffer seriously.
- Labourers suffer, also consumers, creditors.

Also classes with fixed incomes. And consumers generally. Creditors suffer greatly.

(5) A country with inconvertible paper money depreciating in value (because of over-issue) has its foreign exchanges disturbed and foreign trade disorganised.

During and after the War, many European countries (France Italy, Germany, Russia, etc.) have been flooded with inconvertible paper money†—"Where the supply of commodities has been reduced by ten per cent., the means of payment have been generally increased by as many hundreds per cent." The result has been great uncertainty and depreciation in the value of money in every country issuing an excessive quantity of inconvertible paper money, and the great depreciation of money and the rise of prices of commodities have greatly injured creditors, consumers and labourers, disorganised production and dislocated foreign trade and exchanges.

Other things being equal, when paper money is issued and comes in circulation, it will displace metallic money in the circulation. The larger the issue of inconvertible paper, the greater will be the amount of metallic money displaced. *When the quantity of paper money issued exceeds the quantity of metallic money displaced, then we have an over-issue of inconvertible paper, an issue in excess of demand.*

What is overissue of inconvertible paper.

Signs of excessive issue of inconvertible paper.

The over-issue of paper money leads to great evils which have been already enumerated. And so statesmen and economists study carefully the signs which indicate that there has been an over-issue of inconvertible paper.

(1) The first effect and the first sign of an over-issue of inconvertible paper is a *premium on gold*. Inconvertible paper when issued in excess depreciates in value. Premium on gold. Metallic money retains however its former value, and so it now commands a premium in terms

* Cassel—*The World's Monetary Problems.*

of the paper money (in other words, the value of inconvertible paper falls—£1 in metallic money will be worth more than £1 in depreciated inconvertible paper). Persons who require gold to make payments abroad or for other purposes will pay this premium to obtain gold.

(2) This premium on gold is shown also in a rise in the rate of exchange. The rate of exchange is the rate at which foreign bills of exchange are sold; and as these bills are payable in metallic money and generally in gold, a premium on gold will bring about a rise in the rate of exchange.

Thus a country with inconvertible paper money suffers from serious disturbances of its exchange with a country on a gold basis.

(3) Another sign is the disappearance of metallic money. When bad money in the shape of inconvertible paper and good money in the shape of the metallic money are in the circulation together, by the operation of Gresham's law, metallic money disappears from the circulation.

(4) The fourth sign is a rise in prices. This happens when there has been a very considerable over-issue of inconvertible paper, and so the evil has become a serious one; this does not happen when the depreciation of paper money is small, say 2 or 3 per cent.

The price level of the country under a paper money regime thus becomes different from the world price level.

† The regulation of irredeemable paper to prevent over-issue and depreciation.

A considerable body of opinion is entirely against the issue of inconvertible paper by governments.

If inconvertible paper money is at all issued by a government, means should be taken for regulating the amount of inconvertible paper with a view to prevent depreciation and its attendant evils.

(a) Some have proposed to measure fluctuations in price and to increase or decrease the amount of inconvertible paper money in accordance with these fluctuations.

(b) One practicable means to prevent over-issue of inconvertible paper money is to regulate the quantity of inconvertible paper so as to prevent the appearance of a premium on gold. So long as there is no premium on gold, there is no over-issue of paper.

When a government notices a premium on gold, and a rise in the rate of exchange, it should know that there has been over-issue of inconvertible paper. Its duty now (if it can afford it) is to prohibit the issue of any more paper money; and if it finds the dangerous sign of two different sets of prices (one payable in metallic money, and the other payable in inconvertible paper) it should destroy the paper money that returns to its Treasury to reduce the amount of paper money in circulation.

Inconvertible specie.

As there is inconvertible paper money, so there may be inconvertible specie. The Indian rupee is an example of inconvertible specie. It has been remarked of the *Indian rupee* that it is an '*inconvertible note printed on silver*'—the rupee is not convertible into gold, the Indian government is not bound by law to give gold in exchange for rupees, and other inconvertible notes are printed on paper while the inconvertible rupee is printed on silver.

In normal times the artificially high value of the rupee depends upon the limitation of quantity—and this limitation of quantity is made possible by the closing of the Indian mints to the free coinage of silver.

Convertible paper currency.

What is convertible paper?

By *convertible paper currency* we mean notes for which the party issuing the notes will pay *specie on demand*. Con-

vertible paper currency ceases to be convertible when it ceases to be immediately and unconditionally convertible into specie.

By whom is convertible paper issued?

- (a) Convertible paper is generally issued by *banks*.
(b) In some countries, it is issued also by the *government*.

Convertible paper money issued by a bank is called by Walker *bank money*.†

Advantages of convertible and inconvertible paper money compared.

Convertible paper possesses the superior *convenience* and also to a certain extent the *cheapness* of other forms of paper money; while retaining the *comparative stability of value* characterising metallic money and also ensuring automatic regulation of the money supply.

(A) Government convertible paper.

Advantages.

- (a) The fiscal advantage to the Government. (a) By issuing convertible paper, a government can secure a certain amount of revenue without levying any additional taxes.
- (b) The advantages which the people derive from Government inconvertible paper are those which they derive from other forms of paper money, viz., the *saving of capital and labour* used in the production of gold and silver, the *prevention of the wear and tear of coins* and the *superior convenience of paper* for many kinds of payments.
- The advantages to the people.

(B) Convertible bank paper.

Convertible bank paper consists of bank notes issued by banks and convertible on demand into standard or legal tender money.

The comparative advantages and disadvantages of (A) government and (B) bank issues of convertible paper.

The respective advantages of issue by bankers and by government are thus discussed.

(A) *Government convertible paper.*

* Walker—*Political Economy*.

The following objections have been put forward against the issue of convertible paper by Government.

(1) It has been said that the issue of paper money is not a proper function of the government. The answer to this objection depends upon one's ideas as to the proper functions of a government.

(2) Governments issuing convertible paper have often failed in the past to maintain its convertibility—so experience is against government issues.

(3) The danger of excessive issue (inflation) is greater with government convertible paper than with convertible paper issued by banks.

(4) Notes issued by strong and prosperous governments may be more secure than notes issued by banks—but they have more rigidity. A strong objection against government issue is that it is *less elastic* than convertible paper issued by banks*. Bankers increase or diminish the volume of convertible paper according to changes in business demand, and this cannot be done efficiently by government officials ignorant of business conditions.

(B) *Arguments advanced against the issue of notes by private banks.*

(1) If the business of note issue be performed by private banks and not by the government, then the private banks will have great power. And this money power will often be used by the private banks in their own interests and not in the interests of the people.

(2) And notes issued by private banks are in some cases less secure than notes issued by powerful governments. Suitable safeguards, however, will make bank notes practically as safe as government issues.

Conclusion.

The danger expected from government issues makes it generally undesirable for a government to issue notes. *Notes should be issued by a bank or banks, but the banks should be controlled in their note issue by the Government to make the notes secure and protect the interests of the people. And the tendency of modern monetary evolu-*

** Elasticity of paper money.*

As ordinarily used, *elasticity of paper money* means the power of the volume of money to increase with increasing demand for money, and decrease with decreasing demand.

It is desirable to have an elastic currency, a currency varying in volume with varying demand. In different localities, there is an increased demand for money in certain seasons, and in certain industries, e.g.—agriculturists want an increased amount of currency for paying wages and also for small accounts during the busy agricultural season. With elastic currency, like bank notes under suitable conditions, the demands for extra currency in the busy season can be met without extra strain on the money supply in other places and without the expense of transferring specie.

tion is in the direction of bank issues—and not government issues. And in the direction of issue and control by Central Banks.

The ideal currency of economists—a regulated paper currency.

Since Ricardo, and following him more or less, many distinguished economists (Marshall and others) have held that the ideal currency for a country is not gold but a rigidly convertible paper currency. Paper money is more economical and convenient than gold, and also a rigidly convertible paper money is self-regulating. "Immediately the value of notes fell below the value of bullion, the position would be adjusted by the conversion of notes into bullion; and *vice versa*. For international purposes, gold would be used....." Refer to Marshall's evidence before the Gold and Silver Commission (1887) and his *Money, Credit and Commerce*. Keynes in his *Tract on Monetary Reform* suggests a scheme of regulated paper currency.

And a regulated paper currency will have the best chance of success only when the world is ready and ripe for an international paper currency.

International paper money.

"The use of paper instead of gold substitutes the cheapest in place of the most expensive medium, and enables the country without loss to any individual to change all the gold which it before used for this purpose for raw materials, utensils and food; by the use of which both its wealth and enjoyments are increased." (Ricardo—*Principles*.)

The gain to a nation from substituting paper money in place of gold will be multiplied many times if a scheme of international paper can be realized to replace the expensive currencies of nations based on the precious metals. Labour and capital now engaged in producing gold and silver for money purposes would be saved; and a scientific regulation of the quantity of money and its value would be possible with international paper.

The War revived schemes of international paper money.

Schemes of international paper are now but dreams and nothing more; they would require a higher degree of civilization and more cordial co-operation between nations than is possible at the present stage.

Safeguards for the regulation of the note issue (See Chapter on Banking).

The banking theory and the currency theory of note issue. (See Chapter on Banking).

International Distribution of Money—the division of the world's supply of precious metals among different countries

so long as the free movement of gold between countries is allowed by their laws, customs and institutions.

(1) *The theory about the distribution of money.*

Like other commodities, gold and silver distribute themselves among different countries according to the demand for them; they will flow out from places where their value is low, to places where the value is high. -

The proportion which each country gets of the total world's stock of gold or of any new supply is determined by the strength of its demand as compared with the total demand of all countries.

II. *The classical theory about the international distribution of money (the theory of Ricardo* and his followers).*

The answer given to this question by Ricardo and accepted by many early writers is this: The precious metals are so distributed among different countries as to accommodate themselves to the natural traffic which would take place if no such metals existed and the trade between the countries was purely a trade of barter.

Suppose that there is a disturbance of money equilibrium, and a country (A) through increased production of gold in its mines gets a larger supply of money than it requires for its own exchanges (i.e. trade). The increase in the supply of money in the country brings about in it a lower value of money and increases the prices of commodities. Now the prices in A being thus raised, other countries (B, C, etc.) will find it more profitable to sell their goods to A than formerly and so they will send to A more goods than they sent before—the imports of commodities into A from foreign countries will thus be increased by the rise of prices in A.

On the other hand, foreign countries will now buy less in A than formerly on account of the increase of prices in A—so the exports from A to other countries will be diminished by the rise of prices in A.

Imports will thus exceed the exports, and the country will have to export money to pay for the excess imports. *An increase in the quantity of money in a country raises prices in that country; and the rise in prices stimulates imports and discourages exports and thus brings about an exportation of the excess money supply. In a similar manner a deficiency in the money supply of a country brings about a fall in prices in that country, stimulates exports and discourages imports and thus brings about an importation of money to remedy the*

* "Gold and silver having been chosen for the general medium of circulation, they are, by the competition of commerce, distributed in such proportions amongst the different countries of the world as to accommodate themselves to the natural traffic which would take place if no such metals existed and the trade between countries was purely a trade of barter." (Ricardo—*Principles of Political Economy*, Chapter VII).

deficiency in the money supply. *The territorial distribution of money among different countries is thus brought about through the agency of price, through rise and fall in prices.*

***Criticism of the Ricardian theory.**

The Ricardian theory maintains that disturbances in the price level of a country are adjusted by the import or the export of the precious metals, and the following objections have been advanced against it. (a) The Ricardian theory does not pay proper attention to the fact that a disturbance of price level is often adjusted by means other than the movement of specie; (b) and it ignores the modern credit mechanism which renders unnecessary in a large measure gold movements which would otherwise have taken place.

By what means is the transfer of bullion from one country to another prevented in a large degree?

If trade between different nations was carried on only by payment of metallic money in exchange for goods, then there would be a large transfer of metallic money from country to country to make payments for goods (and also to liquidate other kinds of international indebtedness).

International payments are however made largely through credit devices and only the balance is paid in metallic money. *The transfer of bullion from one country to another is thus prevented in a large degree by the developed credit mechanism of the different countries.*

(1) Bills of exchange.

The transfer of bullion is rendered unnecessary in a very large number of cases by the use of bills of exchange. If there were no bills of exchange then an immense amount of metallic money would have to be transferred from country to country to make payments in international trade.

(2) Transfer of securities.

Another device which renders the transfer of precious metals unnecessary in certain cases is the transfer of securities. The balance of indebtedness between two countries is much more likely to produce a transfer of securities than the transfer of bullion from the debtor country.

(3) An export of gold from the debtor country may be avoided or it may be diminished by a skilful *manipulation of the rate of discount.*

(How the rate of discount is manipulated to stop foreign drains of gold is described in the chapter on the foreign exchanges).

Gold movements.

Though the transfer of bullion from one country to another is prevented to a large extent by the developed credit mechanism of modern countries, yet there is some movement of gold from one country

to another. Through international trade and foreign exchange, the gold supply of the world is automatically distributed among the countries which need gold in accordance with the intensity of their respective demands for gold.

Some causes which lead to the movement of gold from one country to another.

The principal causes, which give rise to the movement of gold from one country to another, are the following :—

(1) A country mining precious metals will naturally export them as ordinary merchandise.

(2) The price level of a country exercises a great influence upon the rate of exchange and the movement of gold. If the price level of a country is lower than the international price level, then exports from that country will be encouraged and imports of commodities into the country will be discouraged; and so gold will be imported into the country to adjust the balance. If the price level is higher than the international price level, then gold will be exported.

(3) In normal times (and before the abnormal conditions created by the world economic depression) the rate of interest is a most powerful factor which influences gold movements. By raising the rate of discount the exportation of gold may be stopped or diminished and an importation of gold may be brought about.

The amount of money needed by a country.

The amount of money which is required by a country depends upon its population, the amount and character of its business, the general range of prices, the degree of perfection of its credit machinery, and the extent to which credit is used.

An increased volume of exchange requires a larger or more efficient medium of exchange but not necessarily more money. The increased volume of business will in many cases be met not by an increased quantity of metallic money, but by changing the price level or by an extension of barter or by an improvement in the credit system or by a higher efficiency of money due to improved means of communication or by a combination of one or more of these things.

(Each community will try to make its payments by the method which is least expensive under the given conditions. Metallic money is more expensive than credit money and so no commercial country will keep more gold than is needed to perform its direct money payments and to sustain its credit system. *The amount of metallic money in a country thus tends to a minimum.*)

Money and the world factor.

Whether Britain or India or any other country is to have a satisfactory currency system depends *now* on internal causes and also on world causes. The breakdown of the gold standard in Britain and many other countries was brought about by the lack of international co-operation as regards gold policy, war-debts, reparations. Only international co-operation will be able to restore satisfactory currency conditions based on paper standard or on gold.

The essentials of a good monetary system.

(Refer to page 66—"The Question of the Standard" and to pages 182—184).

The advantages which a country derives from a good monetary system.

(Refer to pages 182—184).

Summary.

(1) The precious metals (gold and silver) have certain qualities which make them better fitted to serve as money than other commodities, and so they have displaced other kinds of commodity money.

(2) Money serves as a medium of exchange, and as a standard of value.

(3) The value of money is like the value of anything else, a question of demand and supply. Other things being equal, and demand remaining the same, the value of money rises or falls *proportionately* with the decrease or increase in the quantity of money.

(4) When two kinds of money are in circulation at the same time, and are together in excess of the monetary needs of the community, bad money drives good money out of the circulation (Gresham's Law).

(5) Bi-metallism has been advocated as providing a stable standard of value and also as benefiting producers, debtors, and as developing foreign trade between silver-using and gold-using countries.

Bi-metallism was replaced gradually by gold-monometallism because gold monometallism is better adapted to rich and progressive communities, is simple, and in the long run, does not produce much greater fluctuation of prices than bi-metallism. But more than half the world (including Britain, U.S.A. etc.) is *now* on the paper standard.

(6) Paper money is cheap, convenient, and provides in emergency a considerable financial resource to the Government; but the evils resulting from an over-issue of inconvertible paper are very great and such over-issue should be carefully guarded against.

(7) Though the transfer of bullion from one country to another is minimised to a very large extent by the use of various credit devices etc., yet there is some movement of gold from country to country due to changes in price level, changes in rate of interest etc.

(8) Appreciation has its advantages and disadvantages and so also depreciation. Generally speaking, steady prices are the best.

Questions.

1. What are the characteristics of good commodity money? Show that gold and silver possess these qualities in a greater degree than any other commodity.

2. What are the functions of money?

3. Define money. Explain the difficulties that beset an attempt to define money (C. U. 1915).

4. (a) What is coinage? Free coinage? Gratuitous coinage? Brassage?

(b) Explain standard money, token money, credit money.

5. (a) What are the purposes for which index numbers are used?

(b) How would you construct a table of index numbers?

(c) How would you show the changes in prices in Calcutta during the last 15 years by index numbers; to what points would you pay special attention? (C. U. 1914).

6. What precautions are necessary in using Index Numbers as a test of change in the purchasing power of money? (C. U. 1927).

7. (a) Discuss the following proposition: "The value of money, like the value of anything else, is merely a question of demand and supply." (C. U. 1912).

(b) "That an increase in the quantity of money raises prices and a diminution lowers them is the most elementary proposition in the theory of currency and without it we should have no key to any other."
—*Mill*.

Examine the statement with special reference to Indian conditions and show how the theory is true only in a simple and primitive state of things (C. U. 1914).

(c) State the Quantity Theory of Money with necessary limitations so as to make it applicable to complex modern industrial communities.

8. How is the value of money determined (a) internally (b) internationally? (C. U. 1932).

9. 'The quantity theory is only an elliptical way of stating the ordinary law of demand and supply.' Explain this statement. (C. U. 1933).

10. What are the possible occasions when the price of an article is expected to go up? (C. U. 1930).

11. 'While changes in the price level . . . influence the rate of interest, it must not be forgotten that on the other hand changes in

the rate of interest itself affect the general price level'. Discuss this statement. (C. U. 1931).

12. What would be the consequence of an arbitrary lowering by a government decree of the price of an article below its competitive level? (C. U. 1930).

13. (a) What is appreciation? depreciation? inflation? contraction?

(b) What are the effects of appreciation and depreciation upon various classes of people? (C. U. 1913).

14. Discuss the various economic consequences that follow from a change in the value of money. (C. U. 1928).

15. State Gresham's Law with all necessary limitations.

How does good money disappear? Does Gresham's Law apply to the Indian currency system? (C. U. 1909.)

16. In what different ways is it possible to combine gold and silver in the currency system of a country? (C. U. 1931).

17. Describe the essential features of bi-metallism and discuss whether bi-metallic standard keep prices steadier than mono-metallic standard. (C. U. 1929).

18. What are the essential characteristics of a gold standard? (C. U. 1928).

19. (a) Outline the main arguments for and against bi-metallism (C. U. 1910).

(b) In what ways is international bi-metallism superior to bi-metallism practised by one country independently of other countries? Discuss whether and under what conditions, the system of bi-metallic money is practicable (C. U. 1909).

Explain the compensatory action of the double standard.

(c) State the case for gold mono-metallism (C. U. 1910).

20. (a) What are the advantages of paper money and what are its disadvantages?

(b) What are the evils which result from an over-issue of inconvertible paper?

What are the signs which indicate that inconvertible paper has been issued in excess?

21. Expound briefly the law of territorial distribution of money among different nations (C. U. 1909).

22. (a) Mention the chief causes which give rise to a movement of gold from one country to another.

(b) By what means is the transfer of bullion from country to country prevented in a large measure? (C. U. 1912).

23. Why is a good currency system important to the economic prosperity of a country? (C. U. 1915).

CHAPTER II.

CREDIT AND BANKING.

What is credit?

(1) *By credit* we mean the power which one man has to induce another man to put economic goods at his disposal for a time, on the promise of the debtor to pay the creditor at some future time. *Credit is thus an attribute of the borrower.*

(2) The term credit is also used to refer to *credit exchange* or credit transaction. The power of borrowing manifests itself in credit transactions. In a cash transaction, present wealth is exchanged for present wealth, in a credit transaction present wealth is exchanged for future wealth.

In a cash transaction there are two elements, (a) the goods sold and (b) the money paid for them in the present. In a credit transaction payment is made at some future time, and so a third element, *the element of time, is added.*

Two forms of credit.

Credit transactions can be divided into two chief classes :

- (1) Sale of goods on condition of payment at some future date.
- (2) Loan of money on condition of repayment at some future time.

Can credit create capital?

- (1) *Mr. Macleod's view.

Mr. Macleod has advanced a somewhat novel view by maintaining that credit creates capital and that credit instruments are real wealth, true capital.

- (2) The correct view.

The opinion that credit itself is a factor of production and can create wealth quite as well as land and labour—this opinion (*Macleod's view*) is clearly wrong.

* "Both money and credit are capital" "Mercantile credit is mercantile capital." (*Macleod—Elements of Banking, Chapters IV and V*).

Unlike Land and Labour, *Credit is not an independent factor or agent of production* creating new wealth. It is only a method of production, consisting in borrowing of capital by one person from another and the use of that borrowed capital in the work of production. (In the words of John Stuart Mill, credit is simply permission to use the capital of others). When one man lends a capital of £1000 to another man, from the national point of view the capital is not doubled, new capital is not created by the mere fact of lending ; only the capital that was in the hands of the lender is now transferred to the hands of the borrower. When a man sees his reflection in the mirror it would be absurd to say that there are two persons ; and it would be equally absurd to say that there are two capitals each worth £1000, one in the hand of the borrower and the other in the hand of the lender, when the lender has lent £1000 to the borrower.

In the words of Ricardo "*credit.....does not create capital, it only determines by whom that capital shall be employed.*"

Advantages of credit.

(1) *Credit helps production by rendering capital more productive.* Though credit is not a factor of production and cannot be regarded as creating capital by the mere fact of lending, still it performs very important services in helping production.

Persons who have much capital and not the ability to manage it, also labourers, servants and other persons who have not enough capital to start business separately, and minors, women and other persons who by reason of their age, sex or occupation cannot engage in industrial enterprises—these persons by means of the credit mechanism are able to transfer their capital to entrepreneurs who will use their capital to the best advantage in the work of production.

In this way much capital which would have been wasted in unproductive consumption, or hoarded or used inefficiently in production is made available for efficient production by competent entrepreneurs.

(2) *Credit stimulates the growth of capital.*

Banks and other credit institutions offering to all classes, rich and poor, suitable opportunities for investment promote thrift and encourage the accumulation of capital.

(3) Credit saves capital by taking the place of corresponding quantities of gold and silver as medium of payment. The economy in the use of money thus effected enables a country to increase its productive capital.

(4) Credit furnishes a more perfect and convenient means of payment in large sums and between distant places than is furnished by the precious metals ; and it thus saves time and labour.

Evils of credit.

The advantages of credit are many and are of very great service to society. We must not overlook, however, the fact that the system of credit is attended with certain evils.

Some have maintained that the use of credit for the purpose of production is always good and that credit for consumption purposes is always evil. This though true in most cases is not always true.

(1) Men borrowing for *consumption* purposes often become extravagant and extravagance frequently leads to fraud and dishonesty of various sorts.

(2) As regards *production*, credit sometimes leads to reckless speculation bringing mischief and ruin in its train. Entrepreneurs use largely the capital of other persons under the system of credit, and having little of their own capital to lose, they in many cases squander other people's money in rash and speculative enterprises.

Mechanism of credit—credit and its organization.

The machinery by which credit operations are carried on consists of two parts :

I. The instruments of credit or the evidence of indebtedness, *e.g.*, cheques, drafts, bills of exchange, notes etc.

II. The institutions of credit consisting of banks and clearing houses.

1. Credit Instruments.

Out of credit transactions arise different kinds of credit paper. The most common of these are (1) bills of exchange, (2) promissory notes and (3) cheques and drafts.

(1) * The Cheque.

(A cheque is an order upon a bank by an individual or a Joint Stock Company etc. holding a deposit in the bank) the order requiring the payment of a certain sum of money by the bank to the bearer of the cheque or to the person named in the cheque.

By means of the cheque, the depositor transfers part of his deposit in the bank to the person to whom the cheque is payable.

The *element of credit* in the cheque is that the person receiving the cheque must have confidence in the man drawing the cheque and in the bank upon which the cheque is drawn ; otherwise the cheque would not have been received by him in payment of his dues.

The cheque is the simplest and most largely used instrument of credit, especially in England and the United States.

(2) Draft.

(A cheque given by a banker upon another bank is usually called a banker's draft.)

(3) Bill of exchange.

(A bill of exchange is an order from a creditor A to a debtor B to pay a sum either to himself A or to a third party C.)

A cheque is an order for payment, so is a bill of exchange. In fact a cheque may be regarded as a species of the genus bill of exchange — 'a cheque is a bill of exchange payable on demand' (Withers—*The Meaning of Money*, Chapter IV).

Suppose Smith has sold goods on credit to Jones, Jones having agreed to pay the price of the goods after three months. Smith then will draw a bill of exchange upon his debtor Jones somewhat in the following manner :

New York, 14th April, 1916.

To Jones (the debtor) London, England.

Three months after sight of this bill pay to C or to order
£100 for value received.

Signed Smith (the creditor.)

Smith is called the *drawer* of the bill and Jones the *drawee*.

(4) Notes.

Notes are of three kinds. (a) Promissory notes issued by individuals and companies promising payment on demand or within a certain time. (b) Bank notes (c) Government paper money.

Bank notes and Government paper money circulate freely as money ; but this is not the case with ordinary credit instruments which are intended to be used primarily in one transaction.

(5) Book credit.

This is very largely used specially in the retail trade. When two firms grant each other book credit, there is no cash payment for each transaction, and only the balances after cancellation of credits and debits are paid in money. This economises greatly the use of money.

II. Credit Institutions—Banks and Clearing Houses.

The trade of banking has been exercised from very early times. It existed in ancient India, Greece and Rome ; and its immense development in the last two centuries has made it a subject of considerable complexity.

Roman examples were forgotten ; and when trade and industry began to revive in the Middle Ages of Europe, the lessons of finance and banking had to be learned afresh. In the Middle Ages banks were money-changers, facilitating trade

by changing one currency for another and enabling merchants to obtain good currency at a time when a great variety of debased coinage was in existence.' Gradually banks began to receive from different persons *deposits of money* for safe custody, and men depositing gold in the banks received in *exchange signed slips of paper* which were soon found to be *extremely convenient for making payments*; and soon the slips of paper practically began to discharge the functions of the bank-note of our own times. And then the regular bank-note was developed and in course of time came state regulation of note-issuing banks to prevent the abuses of over-issue of notes and inadequate reserves. *Cheques based upon deposits developed later on.*

* Functions exercised by banks.

† "Neither a borrower, nor a lender be"—these are the words of advice of old Polonius to his son. But the banker has

Functions of Banks.

(1) *Seligman.*

These three operations of discount, deposit and issue comprise virtually the whole of modern credit transactions (*Principles*).

(2) *Taussig*

"Banks act as agencies for the collection of savings and for investment; they create a part of the medium of exchange (i.e. bank note and bank deposit subject to cheque)." (Taussig—*Principles*, Chapter 24). Banks have thus two classes of functions—(1) borrowing and lending functions (2) monetary functions. (2) *discovery of a better exchange.*

(3) *Fisher.*

Referring specially to the creation of a circulating medium by banks, Fisher has the following:—

"Through banking, he who possesses wealth difficult to exchange can create a circulating medium. He has only to give to a bank his note—for which, of course, his property is liable—to get in return the right to draw, and lo! his comparatively unexchangeable wealth becomes liquid currency. To put it crudely, banking is a device for coining into dollars land, and stoves, other wealth not otherwise generally exchangeable." (*The Purchasing Power of Money*, Chapter III).

(4) *Brown.*

Referring to the work of commercial banks in organizing credit and acting as intermediaries between borrowers and lenders Mr. Brown says 'Banks bring together borrowers and lenders in large number.'

"The banking system combines and co-ordinates—a great deal of waiting which would be done in any case."—(*International Trade and Exchange*, Chapter II).

† Shakespeare, *Hamlet*, I. ii.

to go straight against this advice every day of his banking life. That is his business.

Banks are dealers in credit. Borrowing and lending are the two fundamental transactions of all banking business—banks borrow to lend.

Commercial banks lend to commercial people to help them in their commercial operations; industrial banks lend to manufacturers and others to help them in developing manufacturing and other industries; agricultural banks lend to those interested in agriculture for the ordinary operations and the development of agriculture.

Commercial banks lend to traders for comparatively short periods; industrial banks lend for comparatively long periods to business men engaged in mining, manufacturing, transport, etc..

A bank has some capital of its own and it borrows much larger funds on its credit in the shape of deposits from depositors; and it lends its capital and deposits to persons with good credit lending at a rate higher than that at which it borrowed and thus makes its profit. A bank is the debtor of its depositors and the creditor of those to whom it lends money.

We may sum up the functions of banks thus: Banks (I) help savings and investment by their borrowing and lending, (II) and (by their borrowing and lending) create a part of the medium of exchange (i.e. bank notes and bank deposits subject to cheque) for internal exchanges and some banks help in making payments to foreign countries through foreign exchange operations.

Banks which help savings and investment are known as investment banks. Commercial banks create the largest and most important part of the medium for internal payments (deposits and cheques based on deposits) in the United States, Britain and other English-speaking countries.

The more important functions exercised by banks may be thus enumerated:

- (1) Deposit
- (2) Discount

Banks borrow in the shape of deposits and lend largely through discounting and also in other ways.

Commercial banks, agricultural banks and industrial banks engage in deposit and discount business suited to their respective conditions and circumstances.

Commercial banks in English-speaking countries create the cheque currency (the largest part of the medium of exchange) in connection with their deposits.

Other functions exercised by banks are the following :

(3) Safe deposit.

At an early stage in the history of banking, the people of England deposited their gold with the London goldsmiths for the purpose of safe custody. Now people keep their jewellery, valuable documents and also securities in the safe custody of banks.

(4) Lending money in other ways than by discount, e.g., over-draft which is a loan on the pledge of securities, etc. There are other banks (not commercial banks) which lend on mortgage of land, building and other kinds of property.

(5) Note Issue.

Banks having the right of note issue create a part of the medium of exchange—bank notes.

The function of note issue is not exercised by many banks ; it is a privileged function belonging only to certain banks known as banks of issue. The present tendency all over the world is to centralise the note issue and to give a monopoly of note issue to the Central Bank of each country. The United States of America, however, have not one Central Bank of Issue but a dozen Central Banks.

(6) Payments arising out of international trade and other international transactions between different countries are made through some banks by the purchase and sale of foreign bills of exchange etc. (For an account of the work done by banks in Foreign Exchange, see chapter on Foreign Exchanges).

(7) The function of banker to the Government.

~~The tendency now-a-days is to have a~~ Central Bank in every country. This Central Bank has the monopoly of note issue, is the bankers' bank—and also the banker to the Government.

The Central Banks are the fiscal agents of their respective governments. Such banks help to raise loans for their respective governments, manage the public debt ; keep the government cash balances and exercise other banking functions in connection with the Government.

Definition of a bank.

The Shorter Oxford English Dictionary thus defines a modern bank—“An establishment for the custody of money received from, or on behalf of, its customers. Its essential duty is to pay their drafts on it ; its profits arise from the use of the money left unemployed by them.”

Banks organise the borrowing and lending work (credit) of the community ; they lend their own funds (i.e., capital), and borrowed funds and their own credit to persons engaged in trade, agriculture, manufacturing and other industries. They supply a part of the medium of exchange in the form of bank notes, cheques.

MODERN BANKING OPERATIONS.

1. Deposits (a) cash deposits (b) credit deposits.
Loans make deposits.

How does a bank get the capital for its operations ? The bank carries on its business partly with its own capital but that being insufficient for its purposes it largely borrows money from the public.

The bank borrows money from the public in the shape of deposits.

All depositors do not withdraw all their deposits from the bank at the same time ; and so the bank can safely lend a portion of these deposits. How much the bank can lend depends upon the normal withdrawals of money by the public. If in a country normally 90 per cent. of the total deposits of a bank are not withdrawn, clearly the bank can lend a portion of the deposits not exceeding 90 per cent. of the total deposits

and with the balance of 10 per cent. meet the normal demands for withdrawals by the depositors.

The reserve of cash, which the bank has to keep to meet the demands of depositors, is called the *Banking Reserve*. In different countries this varies from 5 per cent. to as high as 35 per cent. of deposits.

The bank makes a profit by borrowing its deposits at a low rate of interest and lending them at a higher rate.

There are (a) *cash deposits* as described above, and also (b) *credit deposits* created by banks.

"Loans make deposits"—most of the deposits in a bank are not due to cash deposits by the depositors, they are credit deposits created by the loans given by the bank to the depositors—and they are kept in the bank and drawn on from time to time by the depositors by means of cheques.

"In former times the banks dealt only in cash deposits ; now-a-days they deal primarily in credit deposits" ((Seligman—*Principles*).

In the United States, Britain and other English-speaking countries, cheques, based upon deposits, constitute by far the greater part of the circulation used for making payments (much greater than bank notes and metallic money) ; so this deposit function of banks and its proper regulation are of high importance in the economic life of the country.

(*Credit deposits are created in the following way :*

A business man, who wants to borrow, brings to the bank a promissory note, signed by himself and sometimes endorsed by one or more persons ; and if his credit is good the bank discounts the note and credits him with a deposit of the amount of the note minus the interest charged by the bank on a loan. The bank thus lends to the borrower by the creation of a deposit in favour of the borrower, and the borrower will be allowed to draw cheques upon his deposit. After the period of the loan is over, the bank will recover from the borrower the amount lent.

Ordinary commercial banking largely consists of the purchase of personal credit of business men and sale of banking

credit to them by discounting their notes and creating deposits in their favour.

Credit manufacture by banks—how the banks create credit. (C. U. 1932).

"A bank may create credit by (a) issuing notes, (b) loans to business men creating deposits in favour of such business men."

(a) Creation of credit in the form of bank notes.

Suppose a bank issues notes for ten million dollars and has to keep a reserve of four millions in metallic gold. It is not required to keep more metallic reserve in the expectation that only a proportion of the notes may be presented to the bank and metallic money may be demanded in exchange. In normal times all the notes will not be presented by the holders of the notes to the bank on the same day for the purpose of being exchanged into metallic money. The bank lends these notes of the total value of ten million dollars to different business-men. The business men use these notes or paper money as purchasing power to buy commodity or services, and people accept these notes in payment because they have confidence in the bank. In other words, the bank notes circulate as money, because the credit of the bank is good. The bank, by lending ten millions of its paper money, is thus lending its credit. *A bank issuing notes is thus creating credit* and providing purchasing power to the business community. Ten million dollars of paper money—four million dollars of metallic reserve kept by the bank—the additional purchasing power or money created by the bank and based on its credit. This is the way that a bank creates credit by issuing notes; and its power to create credit partly depends upon the metallic or other reserve kept by it for securing the convertibility of the notes and thus maintaining the confidence of the public in the bank.

(b) Creation of credit in the form of credit deposits (and checks currency based upon them). Loans make deposits.

(Before the establishment of the Federal Reserve System a great many commercial banks in the United States of America had the right of issuing notes. They created credit by (a)

issuing notes and (b) loans to businessmen creating deposits in their favour.

In England, the Bank of England—the Central Bank of the country—has a practical monopoly of note-issue. *English commercial banks have no right of note-issue. So they create credit largely by loans to business men which create deposits in their favour and on which they are entitled to draw cheques to the extent of the deposits thus created.*

This kind of credit, manufactured by banks, operates in practically the same way in all English-speaking countries—the United States of America, England, English Colonies, to some extent even India. Let us illustrate the thing from English conditions.

In England, the money, used by merchants and other businessmen to buy commodities and services (*the money of English commerce*), consists very largely of cheques drawn on banks and to a smaller extent of bank notes issued by the Bank of England. (Before the War, gold coins in circulation constituted a still smaller part of the monetary circulation and now they have disappeared from the monetary circulation). Also the money, lent in the London money market (the money of English finance) is the right to draw a cheque upon some bank which gives control over purchasing power in relation to commodity and services. "*The money of modern English commerce and finance is the cheque, and the credit dealt in the London money market is the right to draw a cheque*"—(Withers, *the Meaning of Money*). *How is this money manufactured—this money of modern English commerce and finance? How is credit created by the commercial banks in England? As already stated above, the English commercial banks create credit largely by loans to businessmen creating credit deposits in their favour and cheque currency based upon such credit deposits. In The Meaning of Money, 5th edition, 1930, Mr. Hartley Withers, combining the balance sheets of the five biggest commercial banks, finds that of a total of 1666 million deposits, a small proportion consists of cash deposits and about three-fourths (1249 million pounds) consist of credit deposits which have their origin in loans given by the banks to businessmen and other persons. (And a businessman, having deposited*

cash in the bank (thus having a cash deposit) or having a credit deposit, can draw cheques upon his deposit and thus usually makes his payment. The money of English commerce and finance—the cheque currency—is based upon cash and credit deposits and predominantly upon credit deposits.

A very large proportion of the deposits of a bank in England or in the United States consists of credit deposits. Cash deposits form a much smaller proportion.)

It is maintained (a) that a bank's power to create credit in the form of notes is limited by the reserve it has to keep against the note-issue (b) and that a bank's power to create credit* in the form of cheque currency based upon deposits created by its loans to business men is limited by the reserve it has to keep against such deposits.

The capacity of the ordinary banks to create credit is ultimately limited by the resources of the central bank of the

Do the English commercial banks create credit?

* Leaf also Cannon strongly criticise Withers's idea of regarding the joint-stock banks as creators of credit through their loans making deposits to practically an unlimited extent. "A fashion has grown up lately of regarding the joint-stock banks as "creators of credit."

... By using an ambiguous phrase it is meant to imply that the "banks", meaning the joint-stock banks, can increase to an unlimited extent the amount of credit current. In this sense the idea is plainly untrue. The state is a creator of credit in that sense, because it can not only create paper currency to an unlimited extent, but by making it legal tender can force it into the hands of everyone to whom it owes money. But this power, as we have seen, has been withdrawn from all banks in England. The banks can lend no more than they can borrow—in fact not nearly so much. If anyone in the deposit banking system can be called a "creator of credit" it is the depositor; for the banks are strictly limited in their lending operations by the amount which the depositor thinks fit to leave with them.

It has indeed been argued that every loan by the banks creates a deposit; that so long as the banks go on increasing their loans, so long will their deposits grow in the same degree, and that thus the banks can be regarded as crediting credit. Unfortunately this theory will not stand confrontation with facts. Reference to . . . the course of events in the first half of the year 1925 gives a decisive answer to this hypothesis

The creation of credit in one direction is only made possible by a corresponding cancellation of credit in another; the banks can only lend more to their customers by lending less to the Government"—

Walter Leaf, *Banking*, 1928, pages 101-104.

Cannon in his usual vigorous fashion makes the following criticism :
"In the older and juster view bankers appeared to be intermediaries

country (and sometimes the Government) upon which the ordinary banks ultimately depend for their reserves.

An English commercial bank has its cash reserve (Refer to Bank Reserves. A Bank Balance Sheet, pages 126-129), and it creates credit deposits eight or ten times the amount of its cash reserve. A commercial bank with one million cash reserve and ten million credit deposit (and cheque currency) based upon the cash reserve has manufactured money (credit); and these cheques of the value of ten million pounds will be used as purchasing power by businessmen and will be accepted by persons in payment for their commodities and services so long such persons have confidence in the bank that it has sufficient cash reserve to pay cash for such cheques as may be required. Cheque currency of the value of ten million pounds—one million cash=nine million pounds of additional purchasing power created by the bank and based on its credit. *In this sense the power of a commercial bank to create credit depends upon the amount of its cash reserve.* The cheques, drawn upon its deposits are for the greater part settled through the clearing house (Refer to *Clearing House* p. 121), and the bank requires its cash reserve to meet the small proportion of cheques as are not settled through the clearing house. It seemed to be suggested by Mr. Withers in earlier editions of *The Meaning of Money* that English commercial banks by creating credit deposit (and cheque currency based upon credit deposit) many times the cash reserve have practically unlimited power of creating credit to supply purchasing power to the business community. *The commercial banks are the creators of credit in this sense.*

This view is opposed by Leaf and Cannan and others. It has been pointed out in criticism of Withers that a commercial bank is able to create credit by granting loans to businessmen only so far as businessmen offer suitable security—stock exchange securities, bills of exchange, commodities, etc. In *The Meaning of Money*, 5th edition,

or middlemen between lenders and borrowers; they re-lent what was lent to them, keeping some cash in hand on all ordinary occasions in order that they might be in no danger of not being able to meet any demand that their creditors might make on them (these creditors being mostly entitled to be paid on demand). In the modern view, popularized in this country by Mr. Hartley Withers, and adopted by Mr. Keynes (pp. 178-81), the large share of the whole valuable property of the community possessed by the holders of credit balances at the banks is completely ignored. The bankers are thought of as having (by some means which is left in considerable obscurity) got hold of a certain amount of cash, and then, apparently because there is some magic in calling yourself a banker, being able to "create" eight or ten times as much "money" or "deposit-currency" . . . This, of course, is all moonshine: every practical banker knows that he is not a creator of credit or money or anything else, but a person who facilitates the lending of resources by the people who have them to those who can use them"—Cannan, *An Economist's Protest*, 1927, page 382.

1930, Mr. Withers recognises to some extent the force of the criticism and states "It cannot conduct this manufacture without the assistance of its customers, and it may be contended that these banking credits are manufactured, not by the banks, but by the customers who apply to them, and by the security that the customers bring, and the bankers approve of, as fit collateral. It is certainly true that the banks cannot make advances unless somebody asks for them, and their capacity for doing so thus depends on the needs of the community, and also on the supply of unpledged property that the community has available as security. Whether the manufacture be conducted by the banks or by their borrowing customers is a question of little moment."

When a bank makes a loan and creates a deposit in favour of the borrower, the bank may make the loan on the personal security of the borrower (as already described above) or the bank may make the loan on the security of "collateral, or pledge deposited by the borrower, whether Stock Exchange securities, or bales of cotton or tons of copper; or, again, whenever it discounts a bill. In each case it gives the borrower or the seller of the bill a credit in its books—in other words, a deposit; and though this deposit is probably—almost certainly—transferred to another bank, the sum of banking deposits is thereby increased, and remains so, as long as the loans are in existence. And so it appears that the loans of one bank make the deposits of others, and its deposits consist largely of other banks' loans."

2. Discount.

A commercial bank cannot lend its money for long periods: it may be called upon to refund its deposits at short notice and so it can lend only for short periods.

A commercial bank makes these short period loans by* *discounting* (a) *the promissory notes of businessmen*, (b) *also by discounting bills of exchange* etc. In the modern business world, goods are sold on credit and the manufacturer or the merchant draws his bill of exchange (representing the value of the goods sold) on the purchaser; then the manufacturer or the merchant goes to a bank and by discounting the bill gets its present value, leaving the bank to realise the bill when it falls due, say after thirty days or sixty days or ninety days.

* *Discount is a form of interest*, it is calculated as a percentage of the amount that is repaid by the borrower; while ordinary interest is calculated as a percentage of the amount lent by the lender. Discount is deducted in advance from the principal sum. A lender lending £100 to be repaid at the end of one year and deducting £5 in advance from the principal giving only £95 to the borrower is said to charge a discount of 5 per cent. *A bank is said to discount a bill (or note) when it gives the value of the bill (or note) minus the discount.*

A bank also lends money by making advances on securities and also in other ways.

How much may the Bank lend?

As has been already pointed out, the amount which a bank may safely lend depends upon the normal withdrawals by depositors from the bank. A bank must have a banking reserve sufficient to meet the demands of depositors and any resources beyond this reserve it can lend.

The utility of bankers to the community rests largely upon their power to lend and create credit ; and as noticed already the power of a bank to create credit is limited by the necessity of keeping an adequate banking reserve sufficient to meet the demands of depositors. "The remarkable fact about modern banking is that the reserve may not be kept by the banker himself in actual gold ; he may entrust it to a central or government bank, which carries on ordinary banking business and itself utilises any gold left into it as a basis for creating credit."

Rate of Discount and factors governing it. Market Rate. * Bank Rate in England.

The rate, at which bank loans are made (for example the rate of discount at which the bank is prepared to discount

* "In Europe this is generally called the *discount rate*, and in England the *bank rate*, because the Bank of England is the chief lender ; but in the United States, where up to 1914, most of the advances took the shape of cash loans in New York with the interest payable at the maturity of the loan, it has hitherto been called the *money rate*. Under the new law, however, there will now also be a discount rate."

"Fluctuations in the money rate are due to three causes,—the general rate of interest, the level of prices, and the state of the money market in the narrow sense.

(1) The general rate of interest is, as we know, the payment for the use of capital as a whole. The 'money rate' or 'discount rate' in the long run follows the general rate of interest, for a relative plethora or dearth of capital ultimately finds its way to the lending centres.

(2) . . . Changes in the price level affect the rate of interest, and the 'rate of money' (money rate) in the Wall Street sense is hence partly dependent on the "value of money" in the broader sense . . .

(3) While over longer periods the money rate depends upon the supply of capital and for somewhat shorter periods it is influenced by the level of prices, for still shorter periods it is affected by the temporary amount of loanable cash in the money market. (Seligman—*Principles*, 1929, pages 533-535).

bills of exchange), depends upon the quantity of money held by the bank as a reserve. When the reserve increases, a bank lends more freely to business men and does this by lowering the discount rate and thus attracting borrowers; if its reserve is decreasing, the bank to protect itself will decrease the loans and increase the rate of discount. Business men speaking of "value of money" refer to this rate of interest or discount on short time business loans, and not to the purchasing power of money (Plentifulness of money and "easy money" in their language mean large bank reserves and free lending by banks to business men; "tight money" means a small reserve and a restriction of loans). Bankers are buyers of bills of exchange. The demand for bills comes from banks and as already explained is much influenced by the quantity of money held by banks as reserves. The demand for bills also comes from the bill-brokers. The rate of discount will depend upon the demand for bills and upon the supply of bills in the market and upon general conditions in the market—the central bank's operations, also government finance etc.)—bringing about a scarcity or a plentiful supply of money (which may be used for the purchase of bills) for banks and bill-brokers.

The rate at which the bill-brokers in England discount bills is called the market rate of discount; and this rate depends on the market rate for money at which the bill-brokers are able to borrow from banks. The banks themselves exercise a still stronger and more direct influence on the rate of discount by being themselves large discounters of bills.

Let us consider briefly the English market rate in relation to the English bank rate.

Bank Rate in England.

Bank rate (as distinguished from the market rate) is the official minimum rate at which the Bank of England will discount bills. (Notice that it is only the minimum rate. For when the Bank of England finds that too many bills are being brought to it, it will refuse to take them except at a higher

rate. And for loans and advances the Bank of England charges half per cent. more than for discounting bills.) The market rate may fluctuate from day to day with changes in the supply of and demand for bills. *The bank rate (1) is normally higher than the market rate (2) is not constantly fluctuating like the market rate, and is usually fixed every Thursday morning for a week.*

In England the bank rate is said to be effective when the Bank of England is discounting bills at the official rate or making advances at or above it—the Bank is then in a position to regulate, more or less, the price of money in London. It is a fact that the bank rate is seldom effective; and if the bank wants to discount bills, it has to take them at a lower rate than the official bank rate.

Relation between the discount rate and the general interest rate in a country.

The rate of discount charged by banks in a country and some factors governing the rate of discount—these have been briefly explained.

The general rate of interest in a country depends upon the equilibrium of demand and supply of capital as a whole in the country and it does not depend only upon the quantity of money held by banks as reserves.

The rate of discount depends *immediately* upon the quantity of money held by banks as reserves and upon other factors already indicated. The discount rate (or the money rate in the United States) depends *ultimately* and in the long run upon the general rate of interest in the country. When with increased accumulation the supply of capital in the country becomes more abundant as compared with demand, the general rate of interest falls, and part of the increased supply of capital ultimately goes to the banks and reserves and reduces the rate of discount. With decreased supply of capital in the country as compared with demand, the general rate of interest rises and ultimately there is decreased supply of money in the banks and bank reserves and the rate of discount rises.

The Cheque System. Clearing House.

Deposits are used as the basis of the cheque system. Persons having deposits at a bank make their payments by

drawing cheques against these deposits ; and *the cheque system brings about a great economy in the use of money.*

Suppose two persons, *A* and *B*, have deposits at the same bank. *A* has to pay *B* £100, he will give a cheque of £100 to *B* on his own bank ; and the bank will deduct in its account books £100 from the deposit of *A* and add £100 to the deposit of *B*. *A*'s payment to *B* will thus be made without any transfer of metallic money and an economy of metallic money will be effected.

In large cities, a further economy of metallic money is brought about by means of the *Clearing House*. The customers of each bank send to it for collection on their account all cheques which they receive from their debtors drawn on other banks of the city. Every bank in a large city thus receives every day cheques drawn on other banks, while other banks receive cheques drawn on it.

A Clearing House is a general organisation of the banks in a given place, its chief purpose being to cancel the mutual obligations of banks in the form of cheques. The representatives of each bank bring daily to the *Clearing House* all the cheques it has received against other banks ; and each bank has to meet all the cheques drawn against it. The balances are not settled between individual banks ; they are settled between each bank and the *Clearing House*. A balance is struck between the total sum of each bank's claims (in the form of cheques) against other banks and total claims in the form of cheques) of all other banks against it. When the balance is against a bank, it pays that amount to the *Clearing House* ; and a bank which has a balance in its favour receives from the *Clearing House* the amount of the balance.

An immense economy in the use of metallic money results from the Clearing House system.

It has been calculated that in New York and London the balances paid and received in money by individual banks amount to less than 5 per cent. of the total transactions settled through the *Clearing House*.

In India Clearing Houses have been established in Calcutta, Bombay, Madras, Cawnpore and Rangoon.

* III. Note Issue.

The chief function of a bank is to lend not its money or its capital but its credit.

A bank makes use of its credit by lending a part of its deposits—the depositors have confidence in the credit of the bank, they believe that the bank will return their deposits when required by them and they do not want their deposits returned all at the same time and so the bank is able to lend a part of these deposits. A bank may also lend its credit by issuing notes—it hands over to the borrowers from the bank these notes which they can use in their payments and these notes circulate because the credit of the bank is good.

If the public have confidence in the bank and have no doubt about the security of notes, then the note issue will be limited only by the habits of the people in respect of relative uses which they make of note and coin. Notes are convenient for certain purposes and coin is convenient for other purposes ; *and the relative demands of the public for notes and coin mark the upper limit of the safe issue of notes.*

** Deposit and Note Issue functions—their fundamental similarity.*

A deposit is a liability (debt) of a bank, and so is also a bank-note issued by it. "The notes issued by a bank are thus a liability distinguishable in form only from its liability for deposits, and the functions of deposit and issue . . . are one in substance." (Dunbar—*Theory and History of Banking*, Chapter III; Taussig—*Principles*, Vol. I. Chap. 24).

"So far as the bank and the borrowers are concerned the economic essence of the bank note is identical with that of deposits. Both are bank liabilities, because the bank must ultimately pay its note or honour a requisition on the deposit; both involve the granting of credit to the borrower, who acquires the right to demand payment of a given sum from the bank. The function of issue differs in form, but not in substance, from that of deposit . . . cheques and deposits are sometimes spoken of as deposit currency in contrast to the note currency . . . Bank notes, like deposits are liabilities of the bank in contrast to loans and discounts, which are assets" (Seligman—*Principles*).

Theories about Note Issue.

The Currency Principle and the Banking Principle.

* There have been two schools of opinion in England on the subject of note-issue.

(1) The followers of the currency principle for regulating circulation. (2) The followers of the banking principle or bank liberty.

(1) The currency principle.

The advocates of the currency principle maintain this view—they hold that the true principle of note issue is to keep an almost full reserve of metal for all the notes issued, and to reduce the note circulation by a corresponding amount, as soon as a portion of the metallic reserve is lost by export of gold to foreign countries. They assert that something more than sound banking is needed to give a country a secure note issue; they point out that the issue of notes by banks on the banking principle may and will often lead to an over-issue of notes and inflation of prices.

(2) The banking principle.

The writers advocating the banking principle maintain that the supply of bank notes ought to increase with the increasing demand in

* *The Currency theory is this:*—In issuing bank notes, care should be taken that the amount in circulation should always be the same as the amount of gold would be, provided the notes did not exist. Mr. S. J. Lloyd, better known as Lord Overstone, was the chief exponent of these views, and the following is his opinion as expressed in his evidence before a Select Committee of the House of Commons on the note issue of England in 1840:—

"A metallic currency, I conceive, by virtue of its own intrinsic value, will regulate itself; but a paper currency, having no intrinsic value, requires to be subjected to some artificial regulation respecting its amount. The use of paper currency is resorted to on account of its greater economy and convenience, but it is important that paper currency should be made to conform to what a metallic currency would be, and specially that it should be kept of the same value with the metallic currency, by being kept at all times of the same amount. Now the influx and efflux of bullion is the only sure test of what would have been the variations of a metallic currency, and therefore I conceive that that constitutes the only proper rule by which to regulate the fluctuation of a paper currency."

Their opponents, the upholders of the banking theory, urged, on the other hand, that the only consideration a banker need bear in mind in regulating his issue of notes was whether these issues were made in legitimate banking transactions, as opposed to speculative dealings outside the ordinary commercial channels. If the amount of notes issued in this legitimate manner should be greater than that needed by the country, the excess would inevitably be presented for payment. Sykes—*Banking and Currency.*

a country for an exchange medium. *A bank should be allowed to issue notes in any amount to meet the demands of business* (without keeping a full reserve), *provided there is sound banking and the notes are convertible into coin on demand.* They hold that there will be no over-issue and no inflation of prices if notes are issued on this plan; and they declare that such notes have every virtue belonging to metallic money with the added advantage of greater cheapness and greater convenience in use.

Obviously this school regards bank notes as a form of bank's credit to be expanded or diminished according to the demands of business.

Conclusion.

The currency theorists make an increase in note issue dependent absolutely on an increase in the metallic reserve,—they make an expansion of the paper currency dependent not

Notes issued under the currency principle are perfectly secure, free from danger of over-issue but inelastic.

upon expansion of business demand but upon increase in the output of mines; this is wrong and unsatisfactory in principle; paper currency should be elastic expanding with an increase in the demand for paper currency. Notes issued under the currency principle are perfectly secure being backed by a metallic reserve increasing equally with an increase in the note circulation, but the great defect of such a paper currency is that it is lacking in elasticity and so hampers industrial and commercial progress.

A paper currency issued under the banking principle has the great merit of elasticity; but the notes are not so

Notes issued under the banking principle are more elastic, less secure and subject to danger of over-issue.

secure as the notes issued under the currency principle because the metallic reserve is weaker.* Banks emitting paper currency under the banking principle through an error of judgment and sometimes through deliberate purpose may bring about an over-issue of paper currency and may cause inflation culminating in certain cases in a crisis.

In a satisfactory system of currency, it is desirable to combine as far as possible the elasticity characterising the banking principle with the security and freedom from over-issue associated with the currency

* Advocates of the banking principle maintain that a bank can only circulate a certain quantity of notes determined by business demands and that any over-issue of notes will return to the bank as if contracted by an iron law. But as Pierson points out, the fact that over-issues are returned to the Bank instead of being a safeguard is precisely the thing where the danger lies. "The amount of circulation continues the same, it is true, but its components are not the same; 'uncovered' is substituted for 'covered' circulation and the relation between metallic reserve and note circulation becomes less favourable." Pierson—*Principles*; also Andreades—*The Bank of England* (Vol. II Chapter IV).

theory. This can be done by following a modified form of banking principle providing at the same time adequate safeguards for the security of note issue.

[The controversy between the currency principle and the banking principle agitated England in the first half of the 19th century; and Peel's Bank Charter Act of 1844 was a great victory for the currency-theorists as it regulated English note issue under the currency principle.]

The Bank Charter Act of 1844 has made the note issue of England secure, but inelastic. English bankers and business men soon found a way out of the difficulty created by the inelasticity of note issue by developing the cheque system which provides a perfectly elastic currency expanding readily with an increase in the demand for an exchange medium.]

† Systems of Note Issue in different countries.

The different methods of regulating note issue as prevailing in different countries of the world in actual practice have been variously classified.

(1) The first system consists in limiting the amount of note in circulation by the amount of the reserve. This system prevails in England and was established by the Bank Charter Act of 1844.

The English system of note issue as regulated by the Bank Charter Act is sometimes described as the Partial Deposit System (because most of the notes are based on a gold reserve and some notes are issued against securities). The English system is also known as the Fixed Fiduciary Reserve System. On the other hand, in the Simple Deposit System each note is secured by a metallic reserve of equal value.

(2) Another method consists in fixing a certain ratio between the amount of the reserve and the amount of the notes issued. This system is now found in many countries.

(3) A third plan consists in fixing a maximum of issue— this system is found in pre-war France.

(4) The fourth plan is to compel banks to secure their note issues by means of reliable instruments of value (e.g. Government Bonds or other valuable property). We find this

in the old national banking system of the United States where each bank has to secure its notes by an equivalent amount of Government Bonds deposited in the Government treasury (in addition to other security).

It will be noticed that the third plan is based upon regulations limiting the amount of the notes, the first and the second plans work by regulating metallic reserves and the fourth plan secures note issues by general assets of value and not by metallic reserves.

Existing arrangements as regards Note Issue.

There have been important changes in the systems of note issue in many countries. At present there are two chief systems:

- (1) *The English Fixed Fiduciary Reserve System.*
- (2) *The Proportional Reserve System* which is finding increasing support and which has been adopted by France, Germany, the United States, Russia among other countries.

The Russian Central Bank has to keep a reserve of 25 p. c. against the note-issue, the Bank of France has to keep a reserve of 35 p. c., the Reichsbank of Germany a reserve of 40 p. c., also a reserve of 40 p. c. has to be kept against Federal Reserve notes in the United States of America.

For the respective advantages and disadvantages of these two principal systems of note-issue, refer to pages

Bank Reserves. A Bank Balance Sheet.

Banks now-a-days are mostly joint-stock banks. A joint-stock bank raises its capital from shareholders, it has to pay the profit earned to shareholders, and also keeps a portion of the profit of past years as reserve, (or additional capital) so capital (paid up), profit, reserve fund are its liabilities to its shareholders. But these are not demand liabilities. The shareholders are the proprietors of the bank. And so these are liabilities only in a book-keeping sense.

A bank has liabilities of another sort—demand liabilities, to be paid on demand. It has deposits and has to pay the

depositors on demand, has to meet their cheques on demand. If it has the right to issue bank notes, it has to meet the notes in cash on the demand of the note-holders.

And to meet its demand liabilities—notes and deposits—it has to keep a sufficient reserve in cash or what is equivalent to cash. If it does not maintain a sufficient reserve, and cannot meet its demand liabilities, then the bank fails. It has to close its doors. (Note that this reserve for meeting the bank's demand obligations is an asset of the bank. And it is different from the Reserve fund (called 'the surplus' in the United States), accumulated out of past profits which is a liability of the bank to its shareholders. Also notice that it is different from what is called 'reserve capital' in England—the unpaid capital that must be supplied in certain emergencies by the shareholders).

It is to be kept in mind that the deposits of a modern commercial bank consists largely of credit deposits (see page 97).

The following are the principal items in a bank balance-sheet—the balance-sheet of a commercial bank.

Liabilities.	Assets.
Due to share-holders	Cash in hand, and with other banks and the Central Bank.
{ Capital paid up. Reserve Fund. Undivided profits.	Money at call and short notice
	Bills discounted
Due to customers	Investments
{ Deposits Notes	Advances to customers
	Premises etc.

Attention should be directed to the following points in connection with bank reserves :

(1) *As the reserve is for meeting demand liabilities, it must consist of cash or things immediately convertible into cash (called 'cash items' in the United States of America). It includes*

(i) Cash in hand and with other banks and the Central Bank.

(ii) Money at call and short notice which the bank can quickly realise in cash from bill brokers and others to whom it has made loans for very short periods. In countries having legal-tender paper money, the paper is sometimes counted as a part of the reserve. 'Investments' include stock-exchange securities of high quality, but in times of trouble they are not immediately convertible into cash—they are not saleable. Long-time commercial paper is also not instantly convertible into cash. Short-time commercial bills due within a few days and rediscounted by other strong banks will be a good asset.

(2) In countries where the demand liabilities include both bank notes and deposits, the reserve has to be adequate in character and amount to meet both sorts of liabilities.

In England the Bank of England has the practical monopoly as regards note issue ; in India at present notes are issued by the government, not by any bank. So as regards banks in England and India, the reserve is a reserve against deposit liabilities and not against note issue ; and in England it is often called 'the banking reserve'.

(3) The proportion of the reserve to liabilities is fixed by law in some countries—not in other countries.

In the United States the law compels the Federal Reserve banks to keep a reserve of 35 per cent. against deposits and ordinary member banks have to keep smaller reserves. The Bank of the Netherlands has to keep a specie reserve of 40 p. c. against deposits (and also notes).

In England and India, there is no law laying down the proportion between reserve and demand liabilities. The Bank of England, England's Central Bank, keeps a reserve in practice of 40 p. c. or thereabouts.

No hard and fast rule is possible which will be applicable to all countries—for conditions vary from country to country and even in the same country from time to time.

(4) In banks, the usual method of protecting a decreasing reserve is to raise the discount rate and thus to reduce lending.

In the words of Prof. Seligman "*Successful banking depends largely upon the management of the reserve.*" If a bank keeps too large a reserve, and lends too little, it will be reducing its profit; if it keeps too small a reserve, and lends too much, it will risk its solvency and existence. So the middle path is to be followed between rashness and excessive desire for profit on one side and an excessive timidity on the other. Good management of the reserve means both solvency and profit for the bank and its shareholders. And it means a great deal more. For a solvent and prosperous bank is able to extend credit facilities to its customers—and help materially the development of national industry and trade. The failure of a bank due to bad management of the reserve is a disaster to itself, and its shareholders, its immediate customers—and it gives a shock to the entire business world.†

The objects for which bank reserves are held. The various ways in which the banks protect their reserves. (C. U. 1933).

As has been already explained in connection with the bank balance sheet, a bank has two reserves:

(1) *A reserve fund on the liability side* and this comes from the undivided profit of past years; it is secured fully by assets on the asset side, and these assets are used in normal years as part of the capital to earn profit for the shareholders of the bank, and they are used in emergencies as resources on which the bank can fall back for support.

(2) *A cash reserve (on the assets side) the objects of which are to meet the demand obligation of the bank in the form of notes and deposits.* English commercial banks have no note issue. The cash reserve of an English commercial

* "The modern bank is, so to say, the nerve centre of the business world. A shock to its credit at once ramifies throughout the community, and its failure may paralyse enterprises that seem only to be remotely connected with the particular interests involved. The problem of bank reserves is the one of central importance in the subject of credit (Seligman—*Principles*, 1929, page 518).

bank is thus used to meet demand obligation only in the form of deposits.)

Some of the different ways for protecting the cash reserves of banks in different countries are given below :

(a) Banks to stop lending.

When the cash reserves of the banks of a country are decreasing, the banks may stop further loans and may ask for repayment as regards loans already given by the banks to businessmen. At any time and more so in a time of real difficulty, such a course is not practicable for the banks of a country. In a time of difficulty, if the banks refuse to give loans to businessmen solvent but temporarily in want of money they may precipitate a crisis disastrous to the national economic interests.

(b) To raise the bank rate of the Central Bank and the market rate charged by the commercial banks.

In a time of trade boom with rising prices, increased production of goods and increasing demand for loans on the part of businessmen to finance their business transactions, the banks granting such loans find that their cash reserve is getting smaller in proportion to their demand and other liabilities. This is a dangerous situation for the banks. In such a position, banks in the United States and England, etc., generally used to raise the rate of discount to discourage borrowers and thus to protect the bank reserve.

The banks were helped in their work by the raising of the bank rate of the Central Bank of the country. The rise in the bank rate checked the outflow of gold from the country, encouraged gold to flow in and strengthening the gold reserve of the Central Bank, helped to strengthen the reserves of all solvent banks in the country.

(c) Before the War, the Central Bank of France used to protect its gold reserve by meeting foreign demands on the bank in depreciated silver instead of in gold. The bank had the right to do this under the law of the country. But it prevented Paris from developing into an international money-market centre, as foreigners, knowing that the bills on Paris

might be paid in silver, were unwilling to use the Paris banks for making payment in connection with international trade and other international transactions.

The Balance Sheet of a Central Bank—the Bank Return of the Bank of England.

For the **Bank Return** of the Bank of England, the old form of the return and also the new form more clearly indicating the extent to which the English commercial banks and the Bank of England co-operate in the manufacture of credit, refer to pages 154-158.

Gold Reserve.

The gold reserve is a reserve kept mainly for meeting the demand for gold rising out of international indebtedness in connection with the international trade of the country or otherwise. Some gold is also required as the foundation of the credit structure created by the banks within the country. And the tendency in every modern country is to concentrate this gold reserve in the Central Bank. The importance of the gold reserve in relation to the foreign trade will be explained in the chapter on the foreign exchanges.

*** CENTRAL BANKS.**

The tendency in almost every modern country is to have a central bank—the centre of the banking system.

* To Prof. Dunbar's *Theory and History of Banking*, Prof. Sprague contributes an account of modern Central Banks.

"Somewhere in every banking system a reserve of cash and of lending power is needed to meet occasions when the banks find themselves confronted with unusual demands both for money and for loans

The special functions of central banks may be grouped under three heads: they serve as fiscal agents of government; they have large powers of control over the currency through the more or less complete monopoly of note issue; and finally, since they hold a large part of the reserve of other banks, they are directly responsible for the foundation of the entire structure of credit. This last is by far the most important function of central banks.....

In the exercise of their function in relation to the reserve the possession of government balances is of much advantage, and the privilege of note issue is in most countries indispensable.

OUTLINES OF ECONOMICS

Functions of Central Banks.

The Central Bank is

(A) the bankers' bank (B) also the banker to the government.

A central bank (such as the Bank of England, the Imperial Bank of Germany or the Bank of France) combines the following functions: (Reserve Bank of India.)

..... the loans and other investments of central banks are confined to those which are deemed of the highest quality, a decided preference being given to the trade bill over the collateral loan.

The good quality of the assets in general is important because it gives that prestige which is half the battle for a central bank. A reputation for conservative, sound judgment is absolutely essential to the maintenance of universal faith in the strength of the central institution. For this reason, and even more in order to be able to meet the responsibilities of its position, it is equally essential that a central bank should hold a very large reserve against its credit liabilities..... The proportion of reserve to demand liabilities in the Bank of England is more than 45 per cent. The Bank of Germany holds about the same proportion of reserve to demand liabilities as does the Bank of England, and the reserve of the Bank of France, for many years, has been notably greater than that of any other country.

In times of severe financial strain (i.e., crises) the central bank plays an active dominating role. Upon it rests the responsibility for maintaining specie payments, and also in large measure for the continuance of lending facilities to the business community.....

The policy of liberal loans though at high rates and the payment of money or notes to all who for any reason whatever may demand cash are now everywhere recognised as the guiding principles of action in emergencies."

The Governor of the Bank of England on the functions of a Central Bank. Its main objective.

The Governor of the Bank of England, in giving evidence before the Royal Commission on Indian Currency and Finance in 1926, thus describes the functions of a Central Bank:

"It should have the sole right of note issue; it should be the channel, and the sole channel, for the output and intake of legal tender currency. It should be the holder of all the Government balances; the holder of all the reserves of the other banks and branches of banks in the country. It should be the agent, so to speak, through which the financial operations at home and abroad of the Government would be performed. It would further be the duty of a central bank to effect, so far as it could, suitable contraction and suitable expansion, in addition to aiming generally at stability, and to maintain that stability within as well as without. When necessary it would be the ultimate source from which emergency credit might be obtained in the form of

- (1) (A practical monopoly of the privilege of note issue.
- (2) Keeping the ultimate reserve of the country and being the bankers' bank with which the other banks keep a portion of their reserves and upon which other banks will depend in times of difficulty.

- (3) Acting as fiscal agent of the Government, keeping the balances of the Government and managing its public debt.)

A banking system having such a central bank as its centre is called a centralised banking system ; and a banking system in which there is no such central bank, is called a decentralised banking system.

- (4) Cambridge economists emphasise that the primary task of the Central Bank is to maintain stable the purchasing power of the monetary unit, both internally and externally—to maintain (i) stability in the internal value of money in relation to commodities, (ii) stability in the external value of money in relation to gold or foreign currencies based on gold. Refer to the *Report of the Royal Commission on Indian Currency and Finance*, Vol. I, 1926, page 46.

rediscounting of approved bills, or advances on approved short securities, or Government paper"—Kisch and Elkin, *Central Banks*, 1930, page 105.

"Main objective of Central Banks to Maintain Stability.

The main objective of Central Banks acting in co-operation in the management of the international gold standard should be to maintain the stability of international prices both over long periods and over short periods.... Stability over long periods is largely a question of the adequacy of the quantity of gold available for their reserves taken in conjunction with the proportionate volume of credit created on this basis; stability over short periods, or in other words the mitigation so far as possible of the Credit Cycle, is, we believe, largely a question of co-operative monetary management"—Macmillan Report, 1931, page 121.

Cambridge economists emphasise—and emphasise greatly—the functions and importance of a central bank to every modern country. London economists, Prof. Cannan and others, are somewhat critical of "the new fashionable over-exaggeration of the powers of Central Banks." "Is it quite so certain as some people confidently assume that the price structure is directly dependent upon the volume of bank loans, and is it so clear as these same people imagine that the volume of bank loans is capable of direct control by manipulation of the rate of interest?" asks Dr. Gregory in his address before the annual meeting of the American Economic Association in 1924.

At present it is widely maintained by economists and statesmen that a properly organised central bank is of the utmost importance to the economic and financial stability and prosperity of every modern country. A central bank regulates currency through its control over note issue ; regulates credit as bankers' bank and through the discount rate ; co-ordinates currency and credit, holds suitable reserves economically and efficiently and adjusting supply of currency and credit to demand, performs its primary and essential task of maintaining (i) *stability in the internal value of money (and prices)*, (ii) *stability in the external value of money in relation to gold and foreign currencies based on gold*. It thus renders vast services to national industry and trade within the country ; and fosters international trade.

(5) *And in a crisis the central bank does work of the very highest value.*

"To be, or not to be : that is the question"—even for essentially solvent banks and businessmen in a time of crisis and panic. These essentially solvent banks and business men have enough assets to meet all their liabilities if they get sufficient time to realise their assets. They are only temporarily short of funds to meet their immediate liabilities. National economic interests require they should be helped. When there is a Central Bank, it comes to their help and effectively.

As the bankers' bank, it utilises its large reserve of cash and lending power in time of crisis to give invaluable help to banks and the business community. Then it stands—and stands successfully almost always—between the nation and temporary financial collapse (see Credit and Crises).

" as time passes, we should grow to realise more and more clearly the power of the great central banks of various countries to contribute by co-operative effort to the stability of currency and exchanges, and in general, to the maintenance of financial and economic conditions favourable to the continued progress of the world "

⑤ Britain has its central bank in the Bank of England, France

in the Bank of France, Germany in the Reichsbank. The United States have twelve federal reserve banks (each a central bank for the commercial banks of each section) and all these reserve banks, though independent of one another, are under the direction of a common central authority, the Federal Reserve Board of Washington.

Within the British Empire, India has a sort of central bank in its Imperial Bank established at the end of 1920 by the amalgamation of the three Presidency Banks of Bengal, Madras and Bombay. The Commonwealth Bank of Australia is partly (not fully) a central bank. The South African Reserve Bank was established in 1921, modelled largely on the principles of the federal reserve system of the United States of America.)

Central Banks and their Problems.

The high and increasing importance of central banks in the economic life of modern countries is now generally recognised.

Central Banks and Post-war Stabilisation of Currency.

The International Financial Conference, that met in Brussels in 1920, passed a resolution that "in countries where there is no Central Bank of Issue one should be established."

New Central Banks were established in countries that formerly formed parts of the Austrian and Russian empires, also in South Africa and some of the South American States. The German Central Bank was reorganised as a part of the Dawes scheme. Also a central bank for India was recommended by the Indian Currency Commission of 1926.

In the post-war period, the countries of Europe were suffering terribly from over-issue of inconvertible paper money, and its evil effects in serious dislocation of trade, industry and of the social economy. Coming to realize the vital importance of maintaining a stable currency, different countries, one after another, decided to replace the paper standard by a gold standard, worked by a central bank—in most of the countries "the establishment or reorganisation of the Central Bank of the country was part of a scheme for the stabilisation of the

currency and the prevention of inflation"—Kisch and Elkin, *Central Banks*, 1930, pages 2-3.

The Central Bank as Currency Authority.

Orthodox economists in capitalist countries all agree in regarding the *Central Bank (and not the State) as the suitable currency authority for a country*. They put forward chiefly two reasons in support of their view:

(i) "The rate of discount is the chief weapon for ensuring the due proportion between the volume of credit, the note issue and gold holdings, and thus for maintaining the stability of value of the currency unit, and since the rate of discount is properly the instrument of a bank, there is a sound reason for entrusting to a bank the control of the note issue.

(ii) There is further the danger that if the management of the note issue is entrusted to the State itself, the Government may be tempted to use its power of printing notes as the readiest method of raising funds. Taxation is never popular, and keeping expenditure within due bounds is not always easy. As experience has abundantly proved, increasing the note issue is an all too simple method of temporarily filling in the gap, if the power to do so rests with the Government. Monetary policy should be independent of political contingencies, and the surest way to secure this result is to place the control of the note issue in the hands of a bank. These two considerations, economic and political, explain why the issue of notes has not been left in most countries under the control of the State, but has been handed over to appropriately constituted banks"—Kisch and Elkin, *Central Banks*, 1930, pages 5-6.

Refer to Kisch and Elkin, *Central Banks*, 1930, and also for some very recent developments to *Report of the Gold Delegation of the Financial Committee* (1932) of the League of Nations for

(a) *Relations between the State and the Central Bank.*

(b) *Note Issues and Note and Banking Reserves.*

(c) *Relations between the Central Bank, Commercial Banks and the Money Market.*

(d) *Dealings in Gold and Foreign Exchange, Discounts, Loans and other Business.*

Relation between the State and the Central Bank.

(1) *The Central Bank is the banker to the Government. The Central Bank in all countries keeps the cash balances of the Government and manages the Government debt.*

(2) Is it State-owned and State-managed in all or most countries?

(a) In Socialist Russia following socialist political and economic principles, the Central Bank is state-owned and state-managed—"the State Bank forms part of the People's Commissariat of Finances and is directly subordinate to the People's Commissary of Finances" (Art. 1). The Bank of Finland is another Central Bank which is a true State Bank. The Bank of Latvia is defined in the Statute as a State Bank. The Bank of Australia is not a true Central Bank in the full sense; it is a State Bank.

(b) *In most countries of the world—in Britain, France, Germany, etc.—the Central Bank is not state-owned, it is a shareholders' bank.*

In view of the national importance of the work done by the Central Bank of the country, the Central Bank is subject, in times of peace and more so in times of war, to the ultimate control and supervision of the State. "A government has a vital concern in the efficiency of the Central Bank and cannot be indifferent to its policy."—Kisch and Elkin, Central Banks, 1930, Chap. II. But the post-War tendency is that in times of peace, excessive State interference with the functioning of the Central Bank is discouraged.

The Brussels Conference, 1920, adopted the following resolutions :

"Banks and especially a Bank of Issue should be freed from political pressure and should be conducted solely on the lines of prudent finance." In the leading capitalist countries, this policy of keeping the Central Bank free from political pressure and much State interference, is supported on the following grounds :

(a) Excessive governmental influence in the Central Bank resulting in governmental intervention in banking and currency may bring about over-issue of paper-money (and inconvertibility and depreciation) under the pressure of financial embarrassment to the Government.

(b) "Even apart from such risks there are other serious dangers from a Government-controlled bank A change in the rate of discount, for example, which benefits some may be unwelcome to others. But if the Government has a controlling influence over the Bank, there are obvious ways by which the more powerful interests in the country can try to enforce their wishes. The road is open for political intrigue, and there can be no safeguard that the policy of the Bank will be carried on without bias as national interests require"—Kisch and Elkin, *Central Banks*, 1930, pp. 22-23.

Systems of Note Issue followed by Central Banks.

There are now two alternative systems.

(1) The Fixed Fiduciary Reserve System.

This is the system followed by the Bank of England which is the Central Bank for England. The portion of the note-issue which is not secured by metallic reserve, kept by the Bank of England, is called the Fiduciary or Uncovered Issue; and at any time by the law of the country the amount of the fiduciary note-issue is fixed at a particular figure and it is based upon a Fixed Fiduciary Reserve of securities (not metallic reserve) kept by the Bank of England. In 1844, the amount of the fiduciary note-issue based upon the Fiduciary Reserve was fixed at 14 million pounds; the amount of the Fiduciary Issue (with the amount of the Fiduciary Reserve) was raised gradually till it reached nearly 20 million pounds; in 1928 the amount of the fiduciary note-issue (and the amount of the Fixed Fiduciary Reserve on which it was based) was raised and it was fixed at 260 million pounds. For all notes, issued by the Bank of England, beyond this fixed amount, the Bank of England has to keep 100 p.c. metallic reserve.

Thus as regards note-issue, the Bank of England is said to follow the Fixed Fiduciary Reserve System.

(2) The Proportional Reserve System.

Central Banks of most of the leading countries—United States, Germany, France, Russia, etc., now follow, as regards their note-issue, another arrangement, *viz.*, the Proportional Reserve System.

In the United States, a reserve of 40 p.c. is kept against the Federal Reserve Notes; the Reichsbank of Germany has to keep a reserve of 40 p.c. against its note-issue, the Bank of France a reserve of 35 p.c. and the Russian State Bank a reserve of 25 p.c.

The proportional reserve system is being increasingly adopted and it has been recommended by the Hilton-Young Currency Commission for the Reserve Bank (the Central Bank) proposed for India.

Advantages and Disadvantages of the Proportional Reserve System.

With a proportional reserve system requiring 40 p.c. metallic reserve against the note-issue, an increase of gold reserve in the Central Bank to the extent of 40 millions, makes possible an increase of note-issue by 100 millions. This great elasticity as regards expansion is an advantage when there is increasing demand for money in the country.

But a loss of 40 millions of gold from the reserves of the Central Bank of the country by export to foreign countries or in other ways,

will bring about a decrease of note-issue by 100 millions. This great elasticity as regards contraction of the note-issue may become a great disadvantage, when the demand for money in the country has not decreased to the same extent. It may bring about a large fall in prices with its disadvantages.

Arguments for and against the Fixed Fiduciary Reserve System.

The following arguments have been advanced *against* the Fixed Fiduciary Reserve System of England :

(1) The inelasticity, as regards the expansion of note-issue by keeping the price-level lower, prolonged the period of post-War depression in England.

(2) Such inelasticity is against the practice of other modern countries and increases the difficulties of the business classes in England.

Important arguments for the English system are these :

(1) England has a large export trade and as an international banking centre has to meet large foreign demands for gold. The proportional reserve system, introduced into England, will bring about greatly increased elasticity as regards contraction of note-issue when gold is exported from England to meet foreign demands. That will be a disadvantage. The Fixed Fiduciary Reserve System is better in this respect.

(2) England has large elasticity as regards the supply of purchasing power through her system of deposit banking and cheque currency based upon deposits. So the Fixed Fiduciary Reserve System as regards note-issue may as well be continued.

(3) This system has the advantage, the Bank of England has greater freedom as regards the use of its reserve—"The Bank of England, unlike the Reichsbank, would not come into conflict with the law till it had paid out the last penny of its reserves"—Robertson, *Money*, 1930, page 62.

Smaller Reserve Ratios proposed in connection with the Proportional Reserve System.

"Experience during the past few years has clearly shown that the cover provisions in the statutes of many Central Banks have not been sufficiently elastic to permit the utilisation of reserves for meeting foreign payments to an extent which would be justified in cases of emergency.

The increased volume of short-term funds capable of moving rapidly from one country to another may represent an extra burden on the balance of payments.

Moreover, when the national economy has, for one reason or another, become less flexible, it may take longer to restore a lost equilibrium and during the intervening period a larger amount of gold may have to be exported.

We suggest that the Conference should stress the need of introducing greater elasticity in the primary cover regulations of Central Banks, particularly so as to make the reserves more fully available to meet fluctuations in the balance of payments.

A great advance would be made if legal minimum requirements of gold (or of gold and foreign exchange) were substantially lowered below the customary 33 or 40 ratio." *Monetary and Economic Conference, Draft Annotated Agenda (League of Nations), page 15.*

Bank rate of the Central Bank. Open Market Operations.

The bank rate is an important instrument of the Central Bank for maintaining internal stability as well as external stability in the value of money.

Open market operations are now being increasingly used by Central Banks for credit control and checking undesirable expansion or undue contraction and thus for maintaining stability in business conditions and prices. The open market operations of a Central Bank refer to its entering into direct relation with the general market (and not through member banks or commercial banks) for selling or buying bills and securities with the objects already indicated."

"If, therefore, the Bank seeks to reduce the market supplies of money, the corrective is to be applied by the sale by the Central Bank on its own initiative of bills or securities. The payment for these has the effect of reducing the resources of the commercial banks and of transferring them to the Central Bank. The process has only to be continued until the Bank's rate of discount becomes effective, so that it is again in a position to dominate the market. These open market operations are a most potent weapon in the hands of a Central Bank; for cash to a commercial bank is the base on which an inverted pyramid of credit is raised to several times its volume. A diminution of available cash supplies, therefore, quickly forces a policy of credit restriction on the commercial banks. But it is not only for this purpose that open market operations are of importance. The purchase of bills and securities, by which the cash of the commercial banks is increased, forms the quickest method by which a Central Bank can of its own motion relieve a sudden stringency or prevent its coming by anticipatory action"—Kisch and Elkin, *Central Banks*, 1930, Third Edition, pp. 108-109.

Respective Merits of Bank Rate Method and Open Market Operations as regards Credit Control by the Central Bank.

Credit control by the Central Bank's Open-market Operations for maintaining stability of business conditions and prices has an advantage over credit control by changes in the bank rate. A rise in the bank rate checks undue expansion of credit, but the rise in the rate is a hardship to business men who want to borrow money for their business operations. Credit control by open-market operation is without this disadvantage—"it is surely better that vagaries in the credit machine should be corrected, if it can be done, without inflicting dear money on industry and trade, at a time when they have more than enough difficulties to struggle with." (Withers—*The Meaning of Money*, 1930, page 226).

The bank-rate method is supposed by some persons to be more effective in practice as regards credit control than open-market operations. This is its advantage.

International Co-operation of Central Banks.

International co-operation of Central Banks in credit policy for maintaining stability in business conditions and prices and for checking undue fluctuations in the purchasing power of gold are highly desirable in the interest of every country and the world as a whole.

"The Conference will no doubt wish to emphasise the great importance to be attached to the maintenance of close relationship between Central Banks which will permit them to take account of both national and international considerations when framing their policy. While the responsibility of each one of them for the measures taken on their own markets must be left unimpaired, continuous consultations between them should help to co-ordinate the policy pursued in the various centres and may indeed enable the intervention of an individual Bank to become more effective if supported from abroad.

The Bank for International Settlements represents a new agency for Central Banks and should be able to play an increasingly important part, not only by improving contact but also as an instrument for common action. . . .

. . . We attach great importance to this declaration and to the pursuance of consultations among Central Banks, particularly with a view to achieving the object, as stated in the report of the Gold Delegation, that action must be based on international understanding and co-operation. *The prospects of the general restoration of the gold standard and of its successful working in the future appear to depend in large measure on progress in this field.*"—*Monetary and Economic Conference, Draft Annotated Agenda* (League of Nations), page 17.

"The Central Banks are accused of failure to 'co-operate' and of

insensitiveness to the trend of opinion. Neither of these statements, in its *baldest* form, is in the least true. *There has in fact been a great deal of co-operation*: the European countries returning to the gold standard were assisted to do so by means of stabilization credits; financial reconstruction in Austria, Hungary, and elsewhere was greatly helped by special action by the Bank of England; in the winter of 1927 the Federal Reserve System paid regard to the special needs of Europe; ever since the formation of the Bank for International Settlements the leading Central Banks have been in close touch through the monthly meetings of the Board; in recent months the Bank for International Settlements has advanced huge sums to Germany; the Bank of England came to the assistance of Austria, and both France and the U. S. A. to the assistance of Great Britain. Latterly, France and the United States have reached an agreement for the purpose of protecting the American dollar. It is true that co-operation has been made more difficult by the intrusion at times of political elements; . . . In other cases, no doubt, failure to reach agreement was due to real differences of opinion as to the right course of action to pursue or to real short-run differences of interest between money markets. But such difficulties as these are inevitable and do not justify a general charge of absence of co-operation. As regards the influence of public opinion, it is at least arguable that the Central Banks have been over-inclined to pay attention to it; . . .". —Gregory, *The Gold Standard and its Future*, 1932, pp. 34-35.

The Bank for International Settlements.

The Bank for International Settlements was established in May 1930 for facilitating German reparations payment to the victorious allied countries.

"It was calculated to increase, to some extent, Germany's capacity to pay, and to help to improve the efficiency of the reparations system

By unifying the existing clumsy, complicated and cumbersome reparations organisations, it simplified the whole reparations problem.

. . . A Bank is more suitable than any other organisation to act as trustee for the reparations payments.

It was to be of great help in the commercialisation and mobilisation of the reparations debt. . . .

It was meant to reduce considerably the political character of the reparations problem

It was meant to improve financial relations between former belligerents, by the establishment of a permanent link between their financial authorities.

Some of the authors of the scheme hoped that it might prevent a fall in the international price level and might thus avert a corresponding increase in the burden of reparations and inter-Allied debts"—Einzig, *The Bank for International Settlements*, 1932, Third edition, pp. 34-37.

The Bank for International Settlements represents a new instrument which may be usefully employed to increase international co-operation among Central Banks "and should be able to play an increasingly important part, not only by improving contact, but also as an instrument for common action."

If the nations of the world develop sufficient good sense, goodwill and the spirit of international co-operation and if the governments of the world sincerely desire to co-operate for mutual benefit, then the Bank for International Settlements will be able to play a great and increasingly important part in world economic affairs. Not otherwise.

"Inadequate co-operation has been one of the main reasons why the Bank has so far been unable to satisfy even modest expectations. . . . We have seen that the attempt of France to use the Bank as a political weapon has led to disagreement and friction. . . . So long as genuine co-operation is not established the Bank will continue to suffer through this limitation of its chances. In fact, the lack of co-operation may even jeopardise its very existence.

The hopes attached to the advantages of personal intercourse established between central banks through the Bank for International Settlements have not materialised.

Those who hoped that the Bank would be able to bring about more equal distribution of gold, or at least to check the farther accentuation of the maldistribution, have also been disappointed by events. As we pointed out above, the mere existence of the Bank could not bring about international financial co-operation, without which the scramble for gold could not be checked. Had the principal Governments concerned come to terms as to the basis of a genuine co-operation, the Bank would have provided an excellent channel through which the surplus gold of certain countries could have found its way to countries whose gold reserve was inadequate

For similar reasons it would be unreasonable to blame the Bank for having failed to arrest the fall of world prices. Indeed, at its early stage of development it would have been impossible even to attempt to influence world prices The Bank provides a unique organisation for influencing world prices, provided that agreement is established as to the policy to be pursued, and that those in possession of surplus gold would to that end place their surplus at its disposal."—Einzig, *The Bank for International Settlements*, 1932, Third edition, pp. 130, 132, 133.

THE BANKING SYSTEMS OF DIFFERENT COUNTRIES.

(1) The Banking System of England.

England has got a central bank, the Bank of England, which is the centre of the English banking system.

The Bank of England.

(A) *Its origin.*

The Bank was founded in 1694 to finance William the Third's government. It is the earliest and most celebrated of the great modern public banks and has had a long and illustrious history.

"At the present day it still remains the most famous and from many points of view, the most original bank in the world the development of the Bank is in no way different from the evolution and completion of all other social and political institutions in England. . . . And on these foundations the buildings themselves have been practically raised, curious in form, no doubt, and irregular but remarkable in their solidity, imposing in their appearance and excellent in their practical working."*

Its organization.

The organization of the bank is regulated largely by Peel's Bank Charter Act of 1844 and partly by customary usages and traditions. A striking and peculiar feature of the bank brought about by Peel's Act is the *complete separation of the note issue and the banking departments*—the issue department issues notes and the banking department manages the banking business and deposits but has absolutely no control over note issue.

The Bank is governed by a body of directors; and the directors though practically self-elected have maintained the high prestige of the bank and its predominant influence by the lofty standard of character and conduct observed by them.

The Bank Charter Act of 1844.

(1) What led to the passing of the Act.

In the early days of banking in England, many banks issued notes not secured by a proper reserve of metal, and this frequently led to disaster. The notes of some of these banks came to be worth only the paper they were printed upon; and so there arose a strong demand

* Andreades—*The Bank of England.*

for a note issue in which the note would be a bullion certificate, each pound of note being secured by a pound of metallic reserve.

The Bank Charter Act of 1844 embodying the currency principle was passed by Peel to make the note issue perfectly secure. The note was made practically a bullion certificate.

(2) The provisions of the Act.

The principal features of the Act of 1844 are the following :

(i) The Bank of England is allowed to issue notes up to a limit of fourteen million (£14 millions) on the strength of securities without any specie basis; *for all notes above this amount, the Bank must have specie reserve of £1 for each pound of note issue.* The note issue is thus made thoroughly safe.

(ii) *The issue department and the banking department of the Bank of England are completely separated.* The issue department is to issue notes; and the banking department is to do banking business and to manage deposits without having anything to do with note issue.

(iii) Another provision aims at preventing any increase of note issue of joint-stock and private banks beyond the average at the time of the passing of the Act. The object of the Act is to make the Bank of England ultimately the sole bank of issue

(3) The merits and defects of the Act.

The Bank Charter Act has given England a perfectly secure note issue and this is undoubtedly a great *advantage*.

The Act has however its *defects*. (a) In ordinary times the note issue is inelastic. (b) In a time of crisis, the Act is unworkable and it has to be suspended.

The Act has been suspended in 1847, 1857, in 1866, and virtually again on the breaking out of the last Great War. The suspension of the Act enables the issue department of the Bank to issue notes without keeping a corresponding reserve of metal; and the banking department, with the supply of emergency currency made available in this way, is able to allay panic in the time of crisis. The members of the business public know that they will be able to get if necessary emergency currency from the Bank of England if they can offer good security and so confidence is restored and the panic is stopped.

Its Functions.

The functions of the Bank of England are many and important and they make it the greatest public bank of the modern world.

(i) It has a partial monopoly of the right of issuing notes which in theory is destined to become complete in some future time. (The limit of uncovered note issue laid down by the Bank Charter Act at 14 millions has been gradually raised till

in 1907 it amounted to about eighteen and a half millions. In 1928, the limit of uncovered issue was raised to 260 million

Refer to page 152. Notes above this limit are issued under the currency principle and are secured by a full reserve of metal).

(2) The Banking Department (which is completely separated from the Issue Department) is a pure bank of deposit, the most important bank of deposit in the modern business world, and it is the centre of a vast system of deposit banking.

The Banking Department in addition to other deposits keeps a portion of the deposits of banks. And so it has to keep the reserve upon which other banks draw in time of danger, the reserve which the business community regards as the support of the entire banking system of the country.

The Bank of England thus looks after the banking safety of the whole country.

(3) The Bank of England by manipulating its rate of discount controls to some extent the market rate of discount all over England.

(4) By raising and lowering the rate of discount, it controls the movement of specie from country to country and maintains the central gold reserve for the English money market. (How the rate of discount is used to protect the central gold reserve — this is described in the chapter on the Foreign Exchanges).

(5) London is the clearing house of the world, and the centre of the London money-market (with its great system of joint-stock and private banks) is the Bank of England; so we may regard the Bank of England as the centre of the world's finance.

(6) It keeps the balances of the British Government, which has no other public treasury and manages its finance. It keeps the registry of the English public debt and is charged with the duty of paying the interest on this debt.

A semi-public character thus attaches to the bank though it is a private shareholders' bank and not a government institution.

To sum up.

The Bank of England is a great bank of issue, deposit and

discount ; it is also the English bankers' bank, being the centre and regulator of the entire English banking system and money market ; and at the same time it plays a very important part in the world's finance. Nor must we forget to mention that the Bank is the fiscal agent of the British government.)

Some criticisms of the Bank of England.

Critics have noticed some defects in the Bank of England.

The note issue is inelastic ; and the gold reserve of the Bank in view of the great demands (home and foreign) on it should be strengthened. 'By separating the Bank into two departments the Bank Charter Act tends to increase the fluctuations in the Bank Rate. The same result follows from the clause obliging the Bank to buy all the gold offered to it The administration of the Bank is, it is alleged, somewhat too costly, and its management might with advantage be more permanent.' (Andreades—*The Bank of England*).

"The elasticity of the English system which works with the Bank as its centre is the envy of the world and any alteration, however slight, in so delicate a machine as a credit system, might have effects which were not at all intended" (Withers—*The Meaning of Money*).

The Bank of England is not perfection ; like all human institutions, it has its drawbacks, but it does its work well on the whole.

The Cunliffe Report (1918).

The Cunliffe Committee was appointed to inquire into various problems in connection with currency and the foreign exchanges during the period of reconstruction and also to consider the working of the Bank Act of 1844 and the constitution and functions of the Bank of England with a view to recommending any alterations which may appear to them to be necessary or desirable.

The Committee in its first interim report (1918) '*practically recommended that the Bank Charter Act of 1844 should be restored to full working order with very slight modifications to suit the altered conditions.*' It proceeded to recommend that the Act should be so modified as to make provision for the issue of emergency currency in times of acute difficulty, and it came to the conclusion that the provisions of the Currency and Bank Notes Act of 1914 should be continued in force, under which the Bank of England may, with the consent of the Treasury, temporarily issue notes in excess of the legal limit.

The Cunliffe Report rejected the Holden Plan of a note issue based on bills of exchange with a certain proportion of gold (one-third in Sir Edward Holden's view) which proportion again is reducible on payment of a tax : and it rejected also the proposal for amalgamating the two departments of the Bank of England on the ground that such amalgamation would lead to the state control of banking credit thus

hampering "the elasticity and efficiency with which the banks are able to meet the requirements of industry."

The English Money Market.

(a) Money in the money market sense.

Money in the money market means 'borrowable capital.'

~~The money market is the place where money is borrowed ;~~
and the business of the money market consists (i) in lending money now for the promise of money some day (ii) and also giving money here for money in another country through foreign exchange operations.

Business men borrow in the money market for their business undertakings. The rate of interest charged is called *the price of money*.

(b) Responsibilities of the English money market.

In pre-war England the gold sovereign is unlimited legal tender, silver is legal tender up to £2 and bronze coins up to one shilling only. The Bank note is both cash and credit—it is cash for it is convertible into gold and it is credit because it is a promise to pay on the part of the bank. Like the bank-note, the cheque is also cash and credit. A cheque is simply one class of bill of exchange—there are other classes, viz. ordinary inland bills and also foreign bills of exchange. These are the principal forms of cash and credit in the money market.

(The London money market has a twofold responsibility, national and international—(1) it has to supply credit and currency to its customers in England ; (2) it has to meet foreign bills and drafts on London from all countries of the world and it has to meet these bills and drafts in *gold on demand*.)

(c) Members of the money market.

The London money market includes (i) the *cheque-paying banks*, (ii) *bill brokers and discount houses*, (iii) *accepting houses*,

the most important part ; they create the cheque currency with which English commerce and finance is mainly conducted, they also largely control the price of money (the rate of interest) for day-to-day loans, and also the discount rates for bills of all

dates. The bill brokers are retail dealers in bills of exchange ; and the discount houses are dealers in bills on a large scale and are to a great extent permanent holders of bills. Foreign producers who export goods to England and draw bills have their bills accepted by the accepting houses ; and these accepting houses by lending their signatures and hall mark to these bills give them currency for the purposes of the London money market. The Banks are also acceptors. And the centre of the whole system is the Bank of England.

(d) The Bank Rate. How the Bank of England makes the rate effective and protects its gold reserve.

The Bank rate is the official minimum rate at which the Bank of England will discount bills. The bank rate is ordinarily higher than the market rate of discount charged by other banks in the money market ; and ordinarily it does not control the market rate but when the foreign exchanges turn against England and gold is exported in large quantities, the Bank of England takes steps to control the market rate and stop the drain of gold.

"In order to make its rate effective, the Bank of England often has to borrow money that it does not want, because the market supply of money being abundant, it knows that bankers and brokers will continue to discount bills at rates which will keep the foreign exchanges against England, unless a curtailment of the supply of money is carried out.

The amount that the Bank of England borrows, cancels so much of its liability under deposits in other words reduces the balances of other banks, and so narrows the basis of credit, makes money dear, brings the market rate of discount into some connection with the official rate, influences the foreign exchanges and increases the probability that gold will be sent to London, or that gold will not be taken for export. By this round-about process the Bank finally arrives at its object of protecting or increasing its reserve

(e) The convertibility of English money. The gold reserve.

In pre-war England, the money used consists either of gold or of paper (i.e., Bank notes and cheques) that can be immediately converted into gold—the essential and distinctive

feature of English money is its unquestioned convertibility" (Withers). In pre-war Europe, this immediate and unquestioned convertibility is found only in England and not in France, Germany or any other country, and this is one of the principal reasons as to why London is the centre of the world's finance—in London gold is always to be had, London is the only free market for gold in pre-war Europe.

As compared with its vast responsibilities in connection with the money market of England and also with the world's finance, London's gold reserve is insufficient. Bagehot (Lombard Street) drew attention to this sometime ago, and more recently Mr. Hartley Withers in his remarkable book with a felicitous title "The Meaning of Money."

The War imposed a great strain on the English money market, and London for a time ceased to be a free market for gold and the convertibility of English money was impaired.

The War is over. The maintenance of London as the financial centre of the world is of high importance to Britain—and for this the restoration of an effective gold standard (practically abandoned by Great Britain during the War) is wanted, and there should be no restrictions in London on the legitimate operations of foreign banks which are entitled to their proper share in the world's money market.

And the gold standard in Britain was restored in 1925. Refer to page 152.

Since September 20, 1931, Britain has no longer a gold standard; it has an inconvertible paper standard—the sterling standard (the inconvertible paper pound sterling being now the standard of value).

I. Some important features of the English banking system.

The Bank of England is the centre of a vast system of banking including the large joint-stock deposit banks, the country banks, the country branches of the London banks, etc. Some striking features of the English banking system are the following:

- (1) *The inelasticity of the note issue* (issued under the currency principle).
- (2) *The immense development of deposit banking and the large use of cheques.* (English business men have found compensation for the inelastic note issue in the development of a highly elastic cheque

currency among them). Such a considerable use of deposits and cheques is not found in France and Germany.

(3) *The central and dominating position occupied by the Bank of England in the English banking system.*

(4) The English banking system is adequate as regards the provision of normal short-credits to industry and their distribution; but it has not satisfactory arrangements as regards the provision of long-dated capital. (Refer to the Macmillan Committee Report, pages 169-174.)

Amalgamation in English Banking. Branch Banking.

A recent prominent feature of English banking is the tendency towards *concentration* in the hands of a few very large banking institutions with very large capital and immense deposits.

At the same time the five largest banks of England (known as "*the Big Five*") have enormously extended the system of *branch banking*, having established branches in almost all important towns.

English banks are extending their activities to Scotland and Ireland; and the larger British banks have established branches also in important European towns.

The amalgamation of English banks has been carried out in two ways:

(i) *The old type of amalgamation*, under which local banks were absorbed by larger and more widely spread joint-stock banks.

(ii) *The new type of amalgamation*, under which the larger British joint-stock banks were amalgamated, to a great extent during 1918-20, and resulting in the establishment of the *Big Five*, the five biggest British banks which are also practically the largest banking organizations in the world with enormous resources in capital and deposit and offering great facilities to their numerous customers.

Same arguments for amalgamation:

(1) Larger banks have larger resources and can give more adequate help in the form of more substantial advances to merchants and manufacturers, thus stimulating the trade and industries of the country.

(2) Large organizations make for greater economy, efficiency and uniformity.

(3) Amalgamation has concentrated the control of banking in a few hands, and this makes banking control easier in normal times and also in a time of crisis like a great war.

Same arguments against amalgamation:

(1) *The fear of monopoly.*

When a few banks control the banking resources of a country, it is feared that the money power may be used as a monopoly and in a way injurious to the national interest.

(2) *Decrease of competition.*

Amalgamation has resulted in a decrease of competition among English banks and this is a disadvantage for the customers of the banks.

(3) The great concentration of banking control brought about by amalgamation may result in over-expansion, thus reducing efficiency and financial stability.

Recent Legislation and other proposals and changes in connection with the English Monetary and Banking System.

The Currency and Bank Notes Act of 1914.

When the War started, Britain passed the Currency and Bank Notes Act of 1914, and under the Act the Government was able to issue vast quantity of inconvertible paper money viz. Treasury notes.

Britain was now practically on the inconvertible paper standard. In reality the gold standard was abandoned, as the notes (Treasury notes and also Bank of England notes) ceased to be convertible into gold.

6) The Gold Standard Act of 1925.

The War was over in 1918. After some years, and when it was thought that Britain had sufficiently recovered her economic strength, in 1925 Britain restored the gold standard in the form of the gold bullion standard.

"By the Gold Standard Act of 1925, the right to convert Bank of England notes into gold, which had been suspended after the War, was restored in a modified form. Conversion into sovereigns was not given back to holders of bank-notes, because the country clearly could not afford the luxury of a gold circulation; though in practice the Bank does give sovereigns for its notes at its discretion. But it is obliged by the law to sell gold bullion to anyone who pays for it in legal tender (which in this case means bank-notes), at £3 17s. 10½d. per ounce standard, but only in bars containing approximately 400 fine ounces." —Hartley Withers, *The Meaning of Money*, 1930, pages 25-26.

7) The Currency and Bank Notes Act of 1928.

The Currency and Bank Notes Act of 1928 provided for the fusion of the Treasury notes—a government issue created in 1914—with the Bank of England's note issue and their replacement by the Bank of England £1 and 10s. notes. Further the Act of 1928 provides that the Bank of England may issue notes against securities to a limit of 260 million pounds—the fiduciary issue of the Bank of England is thus raised to 260 million pounds, and every Bank of England note above this limit must be secured by an equal gold reserve.

8) The Macmillan Report, 1931.

The Macmillan Report made important and interesting suggestions on the assumption that England would be able to maintain the gold

standard and the international gold standard would continue to function. ~~The report was presented to Parliament in June 1931. Britain was forced off the gold standard in September 1931.~~

Refer to the Report for (a) General characteristics of Monetary Systems; (b) The International Gold Standard; (c) The Monetary System of Great Britain; (d) The Special problems of Great Britain.

Also as regards *Conclusions and Recommendations* refer to

(a) The Main Objectives of the Monetary System.

- (1) The Gold Standard.
- (2) The International Price level.
- (3) International Currency Management.
- (4) Domestic Currency Management.

(b) Also proposals relating to English Domestic Monetary Policy.

The Macmillan Committee Report recommends (i) that Parliament should give ~~the Bank of England~~ power to issue notes up to a limit of £400,000,000, this figure being subject to modification by law from time to time. Provision should also be made for additional temporary elasticity. (ii) That the Bank of England should by law not be permitted to allow its gold reserve to fall below (say) £75,000,000, except temporarily. . . . In proposing this figure as a statutory minimum the report does not contemplate that the Bank of England would actually allow its gold to fall so low in any ordinary circumstances.

To quote the report, "we should add at once, to prevent misunderstanding, that we are ~~not in favour~~ of a reduction in the Bank of England's normal stock of gold. So far from this being the case, we recommend in para. 354 below that the Bank's normal holdings of gold or its equivalent in foreign exchange should in view of the large liability of London as an international banking centre, be larger than they have been in recent years. What we envisage therefore in the future is a Bank of England with both increased resources and greater freedom. It is necessary, however, to say that freedom and willingness if occasion requires, to export gold in considerable amounts presupposes power also to draw it back from abroad in case of need. This again presupposes that this country maintains a sound position in respect both to its Government finances and its balance of payments"—*Macmillan Committee Report*, 1931, pages 142-143.

The report also recommends that the separation of the Issue and the Banking Departments of the Bank of England should be abolished.

a) September 20, 1931.

In September 20, 1931, Britain was compelled to abandon the gold standard. Britain is now on the sterling standard—an inconvertible paper standard with monetary circulation consisting chiefly of paper money and this paper money is not convertible into gold.

BANK OF ENGLAND.

Return for the week ending on Wednesday, the 1st day of July, 1908.

Issue Department.

	£.		£.
Notes Issued	... 55,484,385	Government Debt	... 11,015,100
"		Other Securities	... 7,434,900
		Gold Coin & Bullion	37,034,385
		Silver Bullion	...
<hr/> Total ... 55,484,385		<hr/> Total ... 55,484,385	

Dated the 2nd day of July, 1908.

Banking Department.

	£.		£.
Proprietors' Capital	14,553,000	Government Securities	... 15,231,766
Rest ...	3,214,385	Other Securities	... 36,347,819
Public Deposits:—		Notes	... 25,508,120
(including Ex-		Gold and Silver Coin	1,573,008
chequer, Savings			
Banks, Commis-			
sioners of National			
Debt, and Dividend			
Accounts) ...	9,648,021		
Other Deposits	... 51,197,083		
Seven-Day and other			
Bills ...	48,244		
<hr/> Total ... 78,660,713		<hr/> Total ... 78,660,713	

BANK OF ENGLAND.

Return for week ended Wednesday, July 12, 1933.

Issue Department.

Notes Issued :—	£.	Government Debt ...	11,015,100
In Circulation ...	378,471,340	Other Government Securities ...	243,818,520
In Banking Department ...	71,223,631	Other Securities ...	1,544,152
		Silver Coin ...	3,642,228
		Amount of Fiduciary Issue ...	260,000,000
		Gold Coin and Bullion	189,694,971
	<hr/>		<hr/>
	449,694,971		449,694,971

Banking Department.

Proprietors' Capital	14,553,000	Government Securities ...	87,055,963
Rest ...	3,510,833	Other Securities :—	
Public Deposits* ...	16,840,467	£.	
Other Deposits :—		Discounts and Advances	15,099,677
£.		Securities	12,545,418
Bankers	95,958,793		<hr/>
Other Accounts	56,334,293		27,645,095
	<hr/>	Notes ...	71,223,631
	152,293,086	Gold and Silver Coin	1,274,394
7-day and other Bills	1,694		<hr/>
			£187,199,083
	<hr/>		<hr/>
	£187,199,083		£187,199,083

The Bank return of the Bank of England is a balance-sheet of a kind and it gives the assets and the liabilities of the Bank as regards its (a) Issue Departments, (b) Banking Department. The Bank of England is divided into these two departments; and they have not yet been combined, though the amalgamation has been recommended by the Macmillan Report.

* Including Exchequer, Savings Banks, Commissioners of National Debt and Dividend Accounts.

The Pre-War Bank Return.

The Issue Department.

In the Bank Return of the pre-War time, we notice as regards the Issue Department, the *liabilities* consist of the notes issued. On the *assets side* there is the Government Debt and Other Securities, totalling little more than 18 millions and forming the Fixed Fiduciary Reserve. The rest of the assets consists of gold coin and bullion providing 100 p.c. reserve against all notes in addition to the fiduciary note issue (the fiduciary note issue is based upon the Fixed Fiduciary Reserve).

The Banking Department.

As regards the banking department the *liabilities* include :

- (1) Proprietors' Capital.
- (2) Rest, consisting of accumulated undivided profits of past years and also the undivided profits of the current year which will be available for distribution to shareholders as profits for the current year.

Proprietors' Capital as well as the Rest belong to the shareholders who are the proprietors of the Bank. They are liabilities of the Bank to its own proprietors and so they are liabilities in a book-keeping sense only.

The Bank's *real liabilities* to outsiders consist of (3) *the Public Deposits*, (4) *the Other Deposits* against which the Bank must provide adequate reserves. *The Public Deposits* are the balances of the various departments of the British Government which are held and managed by the Bank as the Banker of the British Government. These Public Deposits swell in the seasons when the Government is gathering much revenue, and they dwindle much when the Government is making large payments in connection with interest on war-loans and other Government stocks etc. *The Other Deposits* include (a) *the deposits kept with the Bank of England by the Commercial Banks and used by them as cash reserves on the basis of which they create credit*, also (b) *the balances of all the Bank's depositing customers except the British Government and the Commercial Banks*. But (a) and (b) are not shown separately in the pre-War Bank Return; they are separated in the new form of the Bank Return, and this is a great improvement.

The Seven-Day and other Bills form an item of minor importance.

In the pre-War period, the Bank of England, as against its liabilities in connection with Public Deposits and Other Deposits, kept on the *assets side* a forty to fifty per cent cash reserve consisting of notes, gold and silver coins. The notes were convertible into gold on presentation to the Issue Department and were as good as gold, and were thus included in the cash reserve. Such a large cash reserve was maintained, because the Bank of England was the Central Bank of the

country looking primarily to the public interest and safeguarding the banking and financial system of the whole country. The banks, keeping portions of their reserve with the Bank of England, depended upon it for support in times of difficulty and panic, and the Bank of England also held the central gold reserve for the whole country. Moreover, London was the world's international banking centre. The Bank of England was in a way thus the centre of the world's financial system.

The new form of the Bank Return with its improvements.

The new form of the Bank Return with its improvements, was introduced in November, 1928.

(1) The Issue Department.

On the *liabilities side* we find that the notes issued are divided in the new form of return into notes issued (a) in circulation, (b) in banking department. There is also a *very large increase in the notes issued as compared with pre-War conditions*. In pre-War England sovereigns circulated to an important extent; but in England to-day, cash used by the public consists very largely of Bank of England notes.

On the *assets side* we find that the amount of the *Fiduciary Reserve* has increased to £260 millions and the fiduciary note issue based upon this Fiduciary Reserve amounts to the same figure. *This increase in the Fiduciary Issue was brought about in 1928*, when the treasury notes, issued by the British Government in War time, were amalgamated with the Bank of England note-issue. As the fiduciary note circulation is now much larger than it was in pre-War time, the Fiduciary Reserve has been strengthened by the addition of some non-government securities.

Silver is now an item on the assets side; it was not so in the pre-War Bank Return.

The notes of the Bank of England are secured by gold coin and bullion and partly by the large Fiduciary Reserve consisting of Government Debt, Other Government Securities, Other Securities and Silver Coin—but the real security lies in the fact that the notes have been issued by the Bank of England which will be supported in case of necessity by the British Government.

(2) The Banking Department.

The improved form of the Bank Return gives *important new information through the sub-division of the Other Deposits on the liabilities side and Other Securities on the assets side*.

The sub-division of the Other Deposits into (a) Bankers' Deposits, (b) Other Accounts brings clearly to view the Bankers' Deposits which are treated as Cash Reserve by the Commercial Banks and on the basis of which they create credit. So we get a definite idea of the basis available for the creation of credit, and this throws much and needed

light on the position of the English money market as a whole. The Other Accounts include the balances of all the Bank's depositing customers, except the British Government and the commercial banks.

The sub-division of the Other Securities may not reveal much to a man uninitiated in such matters.

The Reserve in the Banking Department consisting chiefly of notes with a small proportion of gold and silver coin, is "the observed of all observers" in the English Money Market. The proportion of the Reserve to the Public and Other Deposits is a matter of high interest and practical importance to the component elements of the money market and to the money market as a whole. It indicates the credit position, also the immediate prospect of credit expansion or contraction.

International Banking Centres. London as the pre-war World's Money Market Centre and Causes.

For many years and till the breaking out of the world-war, London was the world's money market centre. Merchants all over the world used London and London banks for making a great part of the payments in connection with international trade as between different countries. Bills on Paris were not always immediately, unquestionably convertible into gold. For the Central Bank of France had the legal right to meet demands on it in silver and not in gold. Bills on Berlin were not always immediately unquestionably convertible into gold. For the German banks had much of their resources engaged in industrial banking and in the industrial development of the country. In the United States under pre-war conditions during times of panic, gold was not available in sufficient quantities, neither for internal use nor for international payments.

Bills on London (but not on any other centre) were immediately and unquestionably convertible into gold. Again the vast exports of England created a vast demand for bills on London, and so these bills were always more saleable than other bills and on more advantageous terms. So business men of all countries preferred to get their payment by bills on London which had thus become the currency of international commerce—Chinese merchants exporting silk to America and American merchants exporting cotton to Russia, they all liked to have their payments through bills on London which thus became the financial centre of the world."

The Rise of New York and Paris as International Banking Centres.

During and after the Great World War, the United States of America have grown greatly in wealth and financial resources. There has been large improvement also in the economic and financial position of France. Now New York and Paris have become international banking centres. In these circumstances, will London be able to retain her leadership as the world's banking centre?

"Before the war, London was incontestably the world's financial centre. Since the war, however, both New York and Paris have set to themselves the task of acquiring this much-coveted position. New York's endeavour was the result of the accumulation of surplus resources, which had to be reinvested abroad. In Paris the desire to attain supremacy was a natural reaction after the humiliating experiences during the years when French currency was at the mercy of international finance.

"Paris has proved to be a less considerate rival of London than was New York

The apparently uncompromising attitude of France is easily understood if we consider that she had to restore her financial stability without external assistance.

It is perfectly legitimate for a great nation to endeavour to strengthen her position in the field of international finance. As French savings continue to increase rapidly, and the trade balance (including invisible items) is steadily favourable, it is only natural that Paris should rise to a position of importance as an international financier. But this end can equally well be attained by co-operation. . . .

The conclusion is reached that the latter has certain fundamental advantages which will, in the long run, prevail over the superiority of New York's inherent financial strength, or of Paris's liquid resources.

It is not surprising to see three centres at the same time claiming to have attained supremacy; one of them on the basis of its unequalled technical equipment; the second on the basis of the magnitude of its capital resources; and the third on account of the magnitude of its liquid external reserves"—Einzig, *The Fight for Financial Supremacy*, 1931, pages 5—11.

London's superiority lies in the technical excellence of its money market for international banking operations; New York's strength lies in the great volume of its capital resources; and Paris's importance is to be found in the magnitude of its liquid external reserves. The chances are that in future London will have to share with Paris and New York its position as the world's international banking centre.

The great knowledge and experience of the English bankers as regards international banking operations and also their fine sustained courage in handling such transactions with adequate skill and judgment are strong assets of the London money-market.

The eminent British economist, Sir Josiah Stamp, thinks that these are sufficient to enable London to continue to be the world's chief international banking centre, though London has abandoned the Gold Standard.

"It is business which, as I say, requires great knowledge, and, to use colloquial slang, it also requires 'guts.' In certain money markets there is neither knowledge nor guts, for it is no good being extremely courageous one day and taking a lot of business, and then a few days later getting frightened by something, and trying to sell the bills and bonds at a huge discount. That is not the way to secure a world position in this kind of business. So, unless sterling remains very unreliable for a long period, long enough for other people to acquire the knowledge and calmness and equanimity necessary for such business, sterling will remain the chief currency of the world. It may fluctuate over long periods as it has done in the past without harm, and it will be only short-period fluctuations that will damage it. The City of London is not a mere machine grinding out money in a manner which is mysterious to many of us, but it is taking a commanding part in feeding our great population, and this matter of international finance is not one to which you and I can be indifferent"—Sir Josiah Stamp, Halley Stewart Lecture 1931, *The World's Economic Crisis*, 1932, Second Edition, p. 67.

II. The Banking System of France.

(I) The Bank of France is the Central Bank of the French system.

(i) This bank has a *monopoly of note issue*. The French pre-war system has a maximum limit of issue (*viz.*, 1800 million francs, originally fixed in 1870, and increased subsequently), without any other regulations. The metallic reserve kept in practice amounts to $\frac{3}{4}$ or more of the note issue; and the reserve is kept so large partly to make the bank of impregnable economic strength and partly on the political ground of having a large reserve of gold useful in a political crisis, like war etc.

The note issue of the Bank of France is fairly elastic, increasing and decreasing according to changes in demand for it.

(ii) The Bank of France is mainly a *bankers' bank* lending to bankers who, in their turn, lend to the commercial public.

(2) The Bank of France though a private institution is the *fiscal agent* of the government, it keeps the public funds and manages the public debt.

(3) *The use of cheques is much less developed in France than in England and is confined chiefly to Paris and a few other large centres.*

(4) The French banks being restricted from issuing notes and there being also comparatively little use of cheques, *French bankers are less enterprising than bankers in England and in the United States.*

France now follows the proportional reserve system—"the reserve, consisting solely of gold bullion and gold coins must be equal to 35 per cent. of the volume of circulating bank notes and liabilities on current account."

III. The Banking System of Germany.

A brief account of the German Banking System before the War is given below :

(1) In the German Empire, the central bank is the Imperial Bank or Reichsbank; and this though modelled upon the Bank of England has improved upon its model in certain respects, specially as regards note issue and financing the industrial development of the country.

(i) The Reichsbank possesses *practically a monopoly of note issue.* It may issue notes up to 550 million marks without covering them by cash.

* *The note issue of the Reichsbank is an improvement upon that of the Bank of England, because it is more elastic.* The elasticity is secured by allowing the Reichsbank to issue fiduciary notes in excess of the limit on payment of a tax of 5 p.c.

(ii) The Imperial Bank supplies a foundation not only for the circulating medium but also for the structure of industrial credit.

(iii) The Imperial Bank like other public banks (Bank of England, Bank of France, etc.) is managed with a view to public interest rather than the private gain of shareholders.

(2) Some of the great German banks do the business of ordinary commercial banks and they also do investing business in Germany and abroad. The German banks are efficient and enterprising.

(3) The use of *deposits and cheques* in Germany though more developed than in France, is still behind that of England.

The excessive issue of inconvertible paper money in Germany during and after the War brought about an enormous depreciation in the value of German paper money (mark note)—and in August 1924, the German paper mark fell to about a two-millionth of its pre-war value in sterling, being quoted at forty million marks to the pound.

* During the war, a school of economic thought has arisen in Germany with Prof. Liefmann as its leading figure, and Liefmann maintains that *notes require no gold cover*, that notes can be issued on the security of good commercial bills and that notes can be well covered by "staple raw materials of which it would be well to have considerable stocks laid up in case war broke out e.g., copper, nickel, cotton, and so forth."

IV. The Banking System of the United States. The United States before 1913.

In the United States before 1913 there is no central bank; *banking is decentralised both as regards note issue and also to a considerable extent as regards deposit.*

(1) *The government paper currency (greenbacks and gold certificates taken together) is in part a fiduciary issue and in part based on a large gold reserve.*

The rest of the note issue in the United States is practically by national banks, about 7,600 in number. The national banks are allowed to issue notes on depositing Government bonds of equivalent value, as security at the United States Treasury and also every bank has to keep at the Treasury a cash reserve of 5 p.c. of the note issue for securing the convertibility of notes on demand. National bank notes are thus perfectly secure and the note-holders are very completely protected.

(2) *A very important feature of the American system is the great development of deposit banking and the large use of cheques.*

The rules laid down by the state for the protection of depositors are of a very systematic character. The banks are divided into three classes: (a) banks of the three central reserve cities, New York, Chicago and St. Louis, (b) banks of reserve cities, (c) country banks; and each class has to keep a prescribed proportion of cash reserve for the protection of depositors.

The country banks are allowed to keep a portion of their reserve in banks of the first and the second groups; and the banks of the second group are allowed to keep a portion of their reserve in banks of the first group.

The United States has thus got a *partially centralised reserve system*—the reserve banks of New York hold partially the same central position as the Bank of England as regards the keeping of the ultimate banking reserve of the country. This leads to economy in the use of money.

Defects.

The cash reserves in New York are inadequate; and this is a serious element of danger from the standpoint of the banking safety of the country. Other sources of danger lie in the dominance of speculative influences in the New York money market and the inelasticity of bank note issues.

The American system of numerous competing enterprising banks made for great enterprise and thorough diffusion of banking facilities; but *the want of a central bank (or central banks) made these isolated and scattered banks helpless in the time of a crisis.*

Among recent changes, the Federal Reserve Act of 1913 is of high importance, and during the War it helped to concentrate the nation's

store of gold, to conserve its use and effectively to control the gold outflow in connection with foreign trade. Before this Act the nation's gold holdings were scattered among about 32,600 banks (7,600 National Banks and 25,000 State Banks).

The Federal Reserve Act of 1913 and after.

A complete scheme of banking reform in the United States would include :

- (1) centralisation of reserves for strengthening the banking system against the dangers of crises
- (2) centralising the note-issue and making it more flexible
- (3) development of re-discount facilities.

All these things were done by the Federal Reserve Act of 1913.

At first the idea was to have one Central Bank for the United States—as in Britain, France and Germany. But local jealousies and a fear of the vast power which would be exercised by a single central bank led to the following arrangement; '*not one central bank, but a dozen semi-centralised ones,*' each situated in a large city, viz., the Federal Reserve Bank of New York, the Federal Reserve Bank of Chicago, etc.

The whole banking organisation has been made quasi-public, brought under public control and in the public interest.

The Federal Reserve Board.

The central controlling body of the new system is the Federal Reserve Board—consisting of seven members, five appointed by the President of the United States and with the Secretary of the Treasury and the Controller of the Currency as members *ex-officio*. This body has vast powers, the general functions of what may be called "pure banking"; "it has almost unlimited power over the Reserve Banks, being authorised not only to examine all their accounts and affairs, but to remove their officers and directors, to require them to rediscount paper one for another, to suspend reserve requirements, and 'to exercise general supervision.'" It has the power also to appoint three among the nine directors of each Reserve Bank

The Federal Reserve Banks.

The Federal Reserve Banks are bankers' banks—like central banks in other countries they do business mainly with the ordinary banks. These central banks in the U.S.A. are owned by other banks, known as 'member banks'. Individuals are not allowed to hold shares of a Federal Reserve Bank.

The member banks, though they are owners of the Reserve Banks, are not in complete control; as said already, the control is largely exercised by the Federal Reserve Board and in the public interest.

The government not only exercises supreme control through the Federal Reserve Board, it also reserves for itself, any profit above six p.c., provision of course being made for the accumulation of a suitable 'surplus'.

Member Banks.

The member banks deal with the public in connection with their ordinary banking functions—deposit, discount, etc. And they deal with the Reserve Banks—as their central banks, for keeping their reserves, for rediscount facilities etc.

The Federal Reserve System—its advantages.

(1) *Rediscount facilities.*

The rediscount facilities offered by the Reserve Banks to the member banks constitute an important advantage. Formerly these member banks when they discounted commercial paper had their reserves made 'illiquid'; now, after the creation of the Federal Reserve organisation, the member banks have their commercial paper rediscounted by the Reserve Banks and thus their assets become liquid—and they can lend again through discount of paper and in other ways, thus helping the agriculture, industries and commerce of the country.

(Certain critics of the Federal Reserve system declare that the rediscount facilities are often abused for speculative purposes and over-expansion).

(2) *Step towards centralisation of note issue. Increased elasticity of note issue.*

Note issue is to be taken over by the central banks—the Federal Reserve Banks—from the national banks gradually within a period of thirty years. These notes—*Federal Reserve bank notes*—are to be secured by the deposit in the United States Treasury of special securities; and the Federal Reserve Banks are to purchase from the national banks the bonds kept as security for notes.

As different from these "Federal Reserve bank notes" are "*the Federal Reserve notes*". The Reserve Board has complete discretion as regards the issue of these Federal Reserve notes—no limit to the total, nor restrictions as regards the conditions of issue; but the Federal Reserve Banks have to satisfy certain conditions:

(a) they must deposit with the agents of the Federal Reserve Board security for the notes in the way of commercial paper

(b) they must also keep a reserve of 40 p.c., in gold against the notes.

These Federal Reserve notes are further secured by a guarantee of the United States Government.

The practice has grown up for the member banks to take gold to the Federal Reserve Bank and to take in exchange notes. For the Federal Reserve Bank, this gold becomes a reserve, and it can issue 100 dollars of notes for 40 dollars of gold received—the rule being 40 p.c., gold reserve (and 35 p.c., reserve against deposits). *This makes possible a great expansion of the credit system and the circulating medium.*

The limit of 40 p.c. gold reserve may be suspended by the Federal Reserve Board—but in that case a graduated tax of 1 p.c. is to be levied: and if the reserve falls below 32½ p.c., a further tax of 1½ p.c. is to be imposed for every 2½ p.c., deficiency of reserve below 32½ p.c. *So an emergency note-issue is provided.*

In May 1919 there were in circulation 2,521 millions of Federal Reserve notes and 152 millions of Federal Reserve bank notes, while the national bank notes had decreased to 653 millions.

(3) Increased safety against crises through the centralisation of the reserves.

The principal defect of the national banking system—that which led to its overthrow and its replacement by the Federal Reserve organisation—was its absolute failure in times of crises. Under the old system the American banks failed to pay out cash to depositors, they failed to take care of their customers (even those who were essentially solvent) by giving them the much-needed loans—in a time of panic and crisis. Each bank selfishly tried to save itself and its reserve without thinking much of others; and so there was lack of co-ordination and co-operation, resulting in disaster.

All these are changed under the new Federal Reserve arrangements. The member banks have to keep a portion of their reserves against demand deposits with the Federal Reserve Bank. And the Federal Reserve Bank—the central bank—the foundation of the entire structure, must have real strength; it must keep a reserve of 35 p.c., against deposits. (Against notes, it has to keep a reserve of 40 p.c.). And the reserve is to be in legal tender money, which in the U.S.A. (barring the small quantity of green-backs) is gold.

“The real element of strength is in the solidity, the large total reserves, the repute, the governmental backing, of the Federal Reserve Banks themselves. The tendency of the whole series of arrangements—note issue and deposit reserves for the member banks and reserve banks—was toward a situation essentially similar to that which had been developing in other countries; concentration of gold holdings in central reservoirs, withdrawal of gold from everyday circulation” (Tausig—*Principles*, Vol. I, Chapter 27).

The Federal Reserve system has rendered great services to the banks, the industries and commerce of the United States. It has made banking assets more liquid. It has substantially reduced the dangers of panics and crises. And during the last World War, it did very great service to the government of the country. "Under the guidance of the Federal Board, the Reserve Banks became virtually the agents of the Treasury. They made advances of their own to the government in anticipation of bond sales and tax proceeds. Still more important, they urged the member banks—virtually required them—to do the same. It cannot be doubted that the system proved as serviceable to the government as the great European banks did to theirs, and much more serviceable than the scattered banks of the United States had been during the Civil War of 1861-65; with less disturbance, also for the community at large."

V. The Banking and Monetary Systems of India.

The banking system of India includes the following chief elements :—

(1) The Imperial Bank (formed by the amalgamation of the three Presidency banks of Bengal, Bombay and Madras). It is not a true Central Bank, though it acts partly as banker to the banks and banker to the Government.

(2) The Exchange Banks (mainly foreign) which finance the foreign trade and are taking an increasing part in the financing of the internal trade of India.

(3) The Indian Joint-stock Banks organised on the European model and under Indian management which help to finance the internal trade of India.

(4) The indigenous bankers in the villages and in the towns working under the indigenous banking system and including *Mahajans, Shroffs, Marwaries, Chetties*, etc. They play a predominant part in the internal finance of the country.

Short accounts of the Imperial Bank and the proposed Reserve Bank of India (the Central Bank proposed for India) are given below :

A Central Bank for India—the Proposed Reserve Bank :

The Royal Commission on Indian Currency and Finance, reporting in 1926, made three important recommendations :—

(1) *India should have a gold bullion standard in place of the*

Gold Exchange Standard then existing ; (2) that this Currency Standard should be worked and controlled by *a true Central Bank to be established in India* ; and (3) that the new external value of the rupee should be 1s. 6d. gold instead of the old ratio of 1s. 4d. gold for the rupee.

The functions and advantages of the ~~Proposed~~ Reserve Bank.

The proposed Reserve Bank (like any other true Central Bank) will have the following functions and the advantages associated with them,

- (1) to have the monopoly of note-issue and thus to control the currency ;
- (2) to be the bankers' bank in a full sense keeping portions of the reserves of other banks and thus to control credit in the country ;
and through (1) and (2) help on sound lines the banks and the business classes and the economic life of the country ;
- (3) to be the banker to the Government in a full sense and to keep its cash balance and to manage its debt. This will be of substantial advantage to the Government and to the country ;
- (4) to safeguard the banking and the business community in times of crisis and panic by supplying emergency currency and credit. This will be a great service to the banking and business community and the economic life of the whole country.

Re-discount facilities to be supplied by the Reserve Bank :

It is "essential for the development of banking generally that the foundations of the credit organisation should be truly laid. This will only be the case if the commercial banks (a phrase in which are included both exchange and indigenous banks) are able, when the necessity arises, to turn into cash a maximum of their assets with a minimum of disturbance, to general conditions. It is only through the establishment of

a central banking system, with the facilities of re-discounting it affords, that this end can be achieved. Not until then does the commercial banks' most legitimate asset, *viz.*, a short-term advance against goods in the form of a commercial bill, become a quick asset capable of prompt realisation in times of stress. The system, in fact, enables the commercial banks to regard their holdings of commercial bills as their secondary reserves."

The business of a true central bank "in the main, is confined to that of a bank of the banks and of the Government. These functions of necessity require that the character of their business should be of the soundest. Such limitations upon their business prevent these Central Banks from transacting the every-day commercial banking business of the country or from entering into competition with the commercial banks in any general sense. But, in times of stress, they intervene vigorously in the country's business by extending credit facilities liberally. They are primarily concerned with upholding the credit of the country and guiding its financial policy."

The primary task of the Bank.

The goal of all monetary policy is the achievement of stability of the purchasing power of the monetary unit, and the condition under which the sole right of note issue is entrusted to the Bank must clearly be the obligation to maintain stable the purchasing power of the rupee, both internally and externally. The stability will find expression internally in the stability of the general level of commodity prices, and externally in the stability of the purchasing power of the monetary unit in relation to gold and consequently in relation to all exchanges with countries whose currencies are linked to gold through either a gold or a gold exchange standard. To assume this stability it is indispensable that the obligation should be put upon the Bank at all times to buy and sell gold at fixed prices which are laid down in the charter."—*The Report of the Royal Commission on Indian Currency and Finance, 1926.*

The Reserve Bank by co-ordinated control of currency and credit will maintain internal stability in the value of money and maintaining internal stability will help it to maintain external stability.

The Reserve Bank by maintaining the currency standard and helping (a) to maintain internal stability in the value of money and stability of internal prices will promote stability of production, employment, trade and business conditions generally, (b) to maintain external stability in the value of its money as compared with foreign currencies will promote international trade and capital transactions. This will be the primary and essential function of the Reserve Bank—and as already indicated, it will have the greatest advantages from the standpoint of the national economic interest (provided the Reserve Bank is properly constituted and properly worked).

The Gold Exchange Standard. The Proposed Gold Bullion Standard. India at present has a Sterling Exchange Standard.

The Royal Commission on Indian Currency and Finance, 1926, proposed that the then existing Gold Exchange Standard should be replaced by the Gold Bullion Standard, and the Gold Bullion Standard was to be worked by the Central Bank (to be established) as the currency authority for the country.

The Gold Exchange Standard versus a true Gold Standard (whether the Gold Bullion Standard or the other type, namely a Gold Standard with a Gold Currency).

The essentials of the Gold Exchange Standard.

As already stated in page 78, the Gold Exchange standard functioning in India for many years provided (a) internal currency consisting of rupees and notes (with a small quantity of gold coins) for use within the country. (b) The internal currency of rupees and notes was not convertible into gold for internal use, i.e., rupees and notes were not convertible into gold if gold was required for use within the country. (c) The internal currency was convertible into gold (international currency) at an approximately fixed rate (rupee one = 1s. 4d.) for external purposes, i.e., if the gold was required for making foreign payment in connection with international trade and other international transactions.

For securing the convertibility of the internal currency into

gold for external purposes, the Gold Standard Reserve was kept ; and because gold was available to any large extent only for foreign payment (foreign exchanges) it was called a *Gold Exchange Standard*.

The essentials of the Gold Bullion standard.

Under the *Gold Bullion Standard* proposed for India by the Currency Commission, 1926, the internal circulation was to consist of rupees and notes only with no gold coins in circulation ; but the internal currency consisting of rupees and notes was to be convertible into gold for all purposes whether the gold was required for internal use or for external use in connection with the making of foreign payments. The internal currency was to be convertible not into gold coins but into uncoined gold (gold bullion)—hence it was known as the *gold bullion standard*, and it was a true gold standard because the value of the monetary unit was to be kept equal with the value of a fixed weight of gold." "The essence of the Gold Bullion Standard is that the ordinary medium of circulation in India should remain as at present the currency note and the silver rupee and that the stability of the currency in terms of gold should be secured by making the currency directly convertible into gold for all purposes, but that gold should not circulate as money. It must not circulate at first, and it need not circulate ever."—*The Report of the Royal Commission on Indian Currency and Finance, 1926.*

The essentials of the gold standard with a gold currency.

If a *Gold Standard with a gold currency* had been introduced into India, the internal circulation would have included a substantial quantity of gold coins in circulation and also notes and rupees, the internal circulation consisting of notes and rupees would have been convertible into gold coins for all purposes, for internal use and also for making external payments—it would have been a true gold standard because the value of the monetary unit would have been kept equal to value of a fixed weight of gold, and it would have been a gold standard with a gold currency.

Arguments against a Gold Exchange Standard and in favour of a true Gold Standard (either of the Gold Bullion Standard Type or of the Gold Standard with a Gold Currency).

(1) *The Gold Exchange Standard led to inflation and rising prices. This was a principal objection against the Gold Exchange Standard.* With increased demand for currency in the agricultural season, a larger supply of currency in the form of rupees was made available by the government. When the busy season was over, this excess supply of rupees could not be reduced because it was not convertible into gold for internal purposes under the Gold Exchange Standard. The excessive supply of money led to rising prices and attendant evils. (If the excessive internal currency had been convertible into gold, then the gold when required, might have been drained off to foreign countries as gold was international money).

In India the internal trade is a much larger proportion of the total trade than in England. Competent economists like Keynes and others, are of opinion that even for England with its large and important volume of foreign trade, internal trade is of even greater importance, and so it is more important to maintain internal stability in the value of money than external stability. Much greater is the importance of internal trade and internal stability in the value of money to India. The Gold Exchange Standard sacrificed this internal stability. This was a great defect.

A Gold Standard with a Gold Currency, also a true Gold Bullion Standard will maintain internal stability and will be thus superior to the Gold Exchange Standard.

(2) Another serious objection to a Gold Exchange Standard was this:

The vast majority of the Indian people, not understanding the Gold Exchange Standard and the basis of its stability had not confidence in it; and this led to hoarding of gold and checked seriously the banking development of India and thus its industrial and commercial development.

“The mechanism of an exchange standard is refined. Some knowledge of economics is necessary to understand it.

The right of convertibility upon which its stability is based is one of no direct concern to the general public, and it is unintelligible to the majority."

Indian opinion "requires some link that is real, and not only real but conspicuously visible, between the currency of the country and gold."

A Gold Standard with a gold currency, also a true Gold Bullion Standard will enjoy the confidence of the Indian public to a much greater extent than the Gold Exchange Standard ; will thus check the hoarding of gold and promote substantially banking, industrial and commercial development in India.

The Gold Bullion Standard versus the Gold Standard with a Gold Currency for India.

Official apologists of the Gold Bullion Standard as proposed for India put forward the following among other arguments in favour of this kind of standard. Some of the important official arguments are the following :—

(1) *The Gold Bullion Standard is a true Gold Standard maintaining internal and external stability in the value of money and if introduced, will enjoy the confidence of the Indian public ; at the same time, the Gold Bullion Standard is more economical than the Gold Standard with a Gold Currency. For the Gold Bullion Standard avoids the expense of a gold currency.*

This question of *economy* is of substantial importance in a poor country like India.

(2) *The Gold Bullion Standard with gold in reserve and not in currency can have a larger gold reserve than a gold standard with a gold currency ; and the Gold Bullion standard can use its larger gold reserve to provide a greater degree of elasticity as regards the currency arrangements of the country.*

(3) *Under a Gold Standard with a Gold Currency, India will require more gold than under a Gold Bullion Standard. If India gets more gold, there is less gold available for Europe and America bringing about falling prices, rising interest rates, and disturbance to production, employment and trade in*

the world economic system which will also affect injuriously India as a part of the world economic system. The Gold Bullion Standard is free from this disadvantage and is in this respect superior to a gold standard with a gold currency for India.

Arguments for an Indian Gold Standard with a Gold Currency.

When the Currency Commission of 1926 reported, *many Indian economists were in favour of a Gold Standard with a Gold Currency for India.* Some of their chief arguments are given below.

(1) It was pointed out that *the Gold Bullion Standard for India, as proposed by the Currency Commission, (a) with its buying and selling rates of gold so fixed as to prevent the free inflow of gold to India, and (b) also with the provision that gold would be given, if required, only in quantity not less than 400 ounces, was not a true Gold Bullion Standard ; it was a camouflaged Gold Bullion Standard. Such a Gold Bullion Standard would not enjoy the confidence of the Indian public, because the rupee (Indian monetary unit) was not visibly and conspicuously linked to gold. The Gold Standard with a gold currency will be superior in this respect to this kind of Gold Bullion Standard. The Gold Standard with a gold currency will really enjoy the confidence of the people to the full extent.*

There is also *the historical argument in favour of this. In many parts of India, (e.g., South India, etc.) people remember the tradition of a gold standard with a gold currency within the country. Gold currency was in circulation even for a period under British occupation. The Indian people are historically accustomed to it.*

(2) *The fears about an Indian Gold Standard with a gold currency making an excessive demand upon the world supply of gold are exaggerated.*

(3) In the opinion of many Indian economists, "gold standard is eminently practicable in India as she has considerable resources in the shape of gold bullion and securities and as the balance of trade is normally in her favour to a considerable extent. The introduction of an effective gold standard does not necessarily imply immediate and total conversion of the existing token currency into gold. What is needed immediately is the adoption of certain preliminary measures. No fresh additions to currency should be made in rupees or rupee notes. All such additions should be in the form of notes or gold certificates. Thus no immediate additions to currency in the shape of gold coins will be necessary.

For internal purposes, a gold coin to be called 'Mohur' of same fineness and weight as sovereign should be made standard coin of this country and a mint for free coinage of gold should be established."

The Sterling Exchange Standard now in India.

As has been already stated in pages 79, 80, countries comprising more than half the world and including Britain, India and the United States are now on the Paper Standard and off the Gold Standard. *The International Gold Standard may not be restored in the immediate future: the question of a Gold Standard for India is not now of immediate interest. India at present has a Sterling Exchange Standard—the value of the Indian monetary unit (the rupee) having now an approximately fixed value in terms of sterling or the paper pound (Rupee one=rs. 6d. sterling) and not in terms of the gold pound, and rupees being now convertible for external payment at this approximately fixed rate into sterling and not into gold. When rupees were convertible into gold for external payment, India had the Gold Exchange Standard. At present rupees are convertible into sterling (or the paper pound sterling) for external payment, so India has now the Sterling Exchange Standard.*

*** Certain necessary conditions for the establishment of a true Central Bank for India (the Indian Reserve Bank).**

It has been officially suggested that the Indian Reserve Bank can be established when (a) the Indian Government is in a satisfactory financial condition and has no budget deficit, (b) India has a favourable balance of trade, and (c) the world economic situation is more normal.

The first two conditions are now favourable. As regards the third condition the establishment of the Indian Reserve Bank by helping to promote stability of business conditions and prices in India will, to that extent, promote world recovery and action by India in this connection should no longer be delayed. The disturbed economic and financial conditions throughout the world make it all the more necessary that India should have a true Central Bank as soon as possible to co-operate with the Central Banks of the world in credit and gold policy for promoting world recovery.

It is definitely the opinion of the Indian and the British Government that central responsibility cannot be introduced in the Indian Constitution before a true Central Bank is established in India for maintaining stability of currency and exchange conditions.

* "The Committee agrees with the recommendation in paragraph 18 of the Second Report of the Federal Structure Committee that efforts should be made to create, on sure foundations and free from any political influence, and as early as may be possible, a Reserve Bank which would be entrusted with the management of currency and exchange. The Committee are of the opinion that the proposals to be submitted to Parliament should be based on the assumption that such a Reserve Bank would have been created prior to the inauguration of the Federal Constitution, and recommend that steps should be taken to introduce into the Indian Legislature a Reserve Bank Bill conceived on the above lines as soon as is possible. *Certain requirements must be satisfied before the Reserve Bank could start operations with a reasonable chance of successfully establishing itself; in particular, that the Indian budgetary position should be assured, that the existing short-term debt both in London and in India should be substantially reduced, that adequate reserves should have been accumulated and that India's normal export surplus should have been restored.* . . .

The Secretary of State undertook that representative Indian opinion would be consulted in the preparation of proposals for the establishment of the Reserve Bank including those relating to the reserves"—*Report of the Committee on Financial Safeguards, Indian Round Table Conference, (Third Session), Nov.-Dec. 1932.*

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*** Some criticisms of the Indian Reserve Bank (as proposed by the Government).**

The Indian Reserve Bank (as proposed by the Government bill) is to maintain for the present (a) the sterling exchange standard in India, (b) and the ratio of 1s. 6d. sterling for the rupee as its external value—and it is to be a shareholders' bank.

Indian economists and public men are offering criticisms and suggestions in connection with the proposed Reserve Bank. Some of these are briefly noticed below :

(1) *The Indian Reserve Bank Bill has not paid sufficient attention to the banking needs of Indian agriculture, India's chief industry.*

(2) *The Government proposal is that the Reserve Bank is to be a share-holders' bank. As already noticed on page 157 the Central Bank in most countries of the world is a share-holders' bank. Indian public opinion may accept the shareholders' bank idea if a substantial proportion of capital and directorate (say $\frac{3}{4}$ th of the capital and $\frac{3}{4}$ th of the directors) be Indian, thus assuring national control of the Bank to be used in the interest of national trade and industry. (National control is secured by the constitutions of the central banks of Germany, France, Italy, England, Japan).*

(3) *The Government proposal excludes political influence by the Indian Legislature, but at the same time by giving extra-ordinary, unprecedented powers to the head of the Indian executive (the Governor-General) secures the domination of foreign political and economic interests. The Governor-General is constitutionally subordinate to the Secretary of State for India who is naturally under the influence of British political and trading interests. Indian opinion demands that the Indian Reserve Bank should be free from the political influence of Whitehall and the Secretary of State; it should not be dominated by British trade interests.*

The Governor-General is empowered "at his discretion" to nominate four directors and also the Governor and the Deputy Governor of the

* Refer to Mr. Nalini Ranjan Sarkar's speech on the 24th August, 1933 and Sir P. Thakurdas's communications to the Press.

Reserve Bank. The suggestion is made by Indian opinion that the appointment of four Directors, as well as of the Governor and Deputy Governor should be made by the Governor-General on the recommendation of the Indian Finance Member of the Federal Government to be established in India. This will secure some degree of national control. In France the Governor and Deputy Governor of the Central Bank are appointed by the President of the French Republic on the advice of the Finance Minister.

Paragraph 119 of the White Paper proposals lays down—"The consent of the Governor-General given at his discretion will be required for the introduction in the Federal Legislature of legislation which affects . . . the coinage and currency of the Federation or the powers and duties of the Federal Reserve Bank in relation to the management of currency and exchange. . . ." This gives excessive and dangerous restrictive powers to the Governor-General in connection with Indian Currency and Exchange. It means that when the Reserve Bank Bill is passed, it will be impossible to alter or amend it in future, when required in the Indian interest in a case which may be unfavourable to British interest. A proposal for changing the rupee ratio or other proposals which may be necessary in Indian interest but unfavourable to British trade interest, will not get the required previous sanction of the Governor-General. So it will not be possible to introduce a bill for that purpose in the Indian Legislature.

(4) Another suggestion is this: *India at present is on the sterling exchange standard, has temporarily abandoned the gold bullion standard, but expects to return to the gold bullion standard in future*, so gold securities should not be replaced by sterling securities and the minimum holding of gold should be not less than twenty-five p.c. against the note liability. (The Monetary Sub-Committee of the World Economic Conference suggested that 25 p.c. should be the minimum gold holding in modern countries.) *The government proposal about a minimum gold holding of only rupees 35 crores, comes to about 20 p.c. of the existing note liability and is insufficient.*

(5) *The Government is for maintaining at present the rupee at its present value of 1s. 6d. sterling. A suggestion finding general support among Indian public men is about the lowering of the rupee-ratio. The Reserve Bank should work with a rupee reduced in value (a devaluated rupee). A lower value for the rupee and a rise in internal prices will benefit agricultural and other producers and help India's economic recovery.*

(The value of the monetary unit has been reduced in Britain and in the United States and in many countries).

(6) The government proposal to make the Imperial Bank (at present dominated by non-Indian interests) the sole agent of the Reserve Bank is condemned by Indian opinion. Such a proposal, if carried into effect, will give the Imperial Bank, a gigantic competitor, an unfair advantage over Indian Banks and will check their development.

It is strongly maintained by some of the ablest Indian economists that *no Reserve Bank is better than a bad Reserve Bank*. A bad Reserve Bank, with a constitution giving excessive and unprecedented powers to the Governor-General, and thus securing the domination of foreign political and economic interests now and in future and making the Indian Legislature and the Indian Finance Member of the new Federal Government to be established almost powerless as regards Indian currency, exchange and banking policy—this will be no improvement.

The Imperial Bank of India.

The Imperial Bank of India was established on the 27th January 1921 by amalgamation of the three Presidency Banks of Bengal, Bombay and Madras. It was created by the Imperial Bank of India Act (Act XLVII of 1920).

The idea of a Central Bank for India goes back to 1836 and Mr. James Wilson wrote a minute on the subject in 1859. In 1867 Mr. Dickson, the brilliant Secretary of the Bank of Bengal, put forward proposals for the amalgamation of the three Presidency Banks and a concrete and constructive scheme for a great banking establishment for British India. The matter was discussed later on different occasions including an examination of the question by the Chamberlain Commission of 1913. Competent economists like Mr. J. M. Keynes and others and political authority in the form of the Government of India being in favour of the establishment of a Central Bank and the Presidency Banks themselves desiring such an amalgamation.

(as a result of the experience gained during the War and also for strengthening and extending the banking system in India), the Imperial Bank was brought into existence.

Constitution of the Imperial Bank.

The capital of the Imperial Bank is Rs. 11,25,00,000 divided into shares of Rs. 500 each, (as compared with a total of Rs. 3,75,00,000 for the three Presidency Banks together) ; and the increased capital has been secured by issuing new shares.

The business of the Imperial Bank is managed by a Central Board of Governors assisted by Local Boards in Calcutta, Bombay and Madras and such other places as may be decided on by the Central Board.

The Central Board of Governors consists of :

(1) The Presidents, Vice-Presidents and Secretaries of Local Boards.

(2) Managing Governors not exceeding two in number, appointed by the Governor-General in Council on the recommendation of the Central Board.

(3) The Controller of Currency or other officer nominated by the Governor-General in Council.

(4) Not more than four non-officials to be nominated by the Governor-General in Council.

The management of the Bank is conducted by the two Managing Governors and the three Secretaries under the control of the Central Board of Governors.

Functions of the Imperial Bank.

The Imperial Bank of India inherits the privileges and restrictions of the Presidency Banks with some minor modifications.

The Imperial Bank at present transacts the following classes of Government business and also commercial business.

(A) Government Business.

The Imperial Bank acts partly as banker for Government :

(i) It keeps Government balances (or funds) at head-quarters and at its branches and with the establishment of more branches it will keep all Government balances and Government treasuries will be abolished. The Government Reserve Treasuries have already been abolished. Acting as banker for Government, the Imperial Bank remits money or lends on securities on behalf of Government.

(ii) The Imperial Bank issues Government loans and manages the Public Debt, as the Bank of Bengal used to do.

(B) Commercial Business.

The Imperial Bank in its commercial business is subject to general restrictions similar to those which were imposed on the old Presidency Banks.

The Imperial Bank is permitted to have a London Office, but it (like the Presidency Banks) is not allowed to deal directly with the public in foreign exchange though it may transact business in London on behalf of Government, public bodies and other banks. *Within India, the Imperial Bank undertakes deposit, discount and other banking functions and is partly a sort of bankers' bank.*

In India its commercial business is subject to the following restrictions. "Generally speaking the Imperial Bank may not make loans or advances for a longer period than six months, nor upon the security of immoveable property (that is mortgage of houses and lands) excepting as collateral security where the original security is either a gilt-edged security or goods which are pledged to bank. It may not buy or discount bills which do not bear upon them the signatures of two persons or firms unconnected with each other in general partnership ; but this does not prevent the granting of temporary overdrafts to persons who keep regular accounts with the bank."

Within five years the Imperial Bank has to open 100 new branches of which the Government may determine the location of 25. These new branches are expected to increase substantially banking facilities within the country.

: The Imperial Bank not a full-fledged Central Bank.

From the functions at present discharged by the Imperial Bank, it is clear that the Imperial Bank of India is not a full-fledged Central Bank like the Bank of England or the Bank of France or the Reichsbank of Germany.

The Imperial Bank is not a full-fledged Central Bank because :

(i) It has not the note issue function which is exercised as a monopoly function by the Bank of England in England, the Bank of France in France or the Reichsbank in Germany.

(ii) It is not the bankers' bank in India as fully and effectively as the Bank of England is the bankers' bank in England or the Reichsbank is the bankers' bank in Germany.

Also in England the Bank of England regulates foreign exchange and gold exports which is not done in India by the Imperial Bank.

(iii) The Imperial Bank also at present does not hold all the Government balances. It is not the banker to the Government in the full sense.

Relation of the State to the Imperial Bank.

(i) *The Indian Government has an important voice in the management of the Imperial Bank.*

The Central Board of Governors is ultimately responsible for the management of the Imperial Bank. And the Indian Government appoints two Managing Governors, the Controller of Currency or any other officer and not more than four non-officials to the Central Board.

The Government is also entitled to stop any action of the Central Board likely to be detrimental to the Government.

(ii) *The Imperial Bank partly acts as banker to the Government*

(a) by keeping large Government balances and remitting money and lending on securities on behalf of Government.

(b) by issuing Government loans and managing the Public Debt.

(iii) The Imperial Bank is, however, not a Government Bank, it is not owned by the Government nor it is entirely managed by the Government.

The shareholders of the Imperial Bank are private persons and they are the proprietors of the bank and they have a share in the management.

The essentials of a good monetary system ; and the advantages which a country derives from such a system of money.

Money in a good currency system would perform properly the different functions of money, that is, it should be a good medium of exchange, it should be a good measure of value, and it should be a good standard of deferred payments.

(a) To perform money functions properly, *stability in the value of money is essential*. A money, the value of which fluctuates, will not be a good medium of exchange, will not be a good measure of values and will be a bad standard for deferred payments because the instability in the value of money will cause undeserved gains and losses to exchangers.

As already pointed out in pages 52, 53, stability in the internal value of money prevents undeserved gains and losses to the different classes within a country and maintaining stability of prices promotes stability of production, employment, trade and business conditions generally. It helps to stimulate exchange within a country and the stimulation of exchange leads to an extension of division of labour and increase in the productive efficiency of the country and thus to economic prosperity. A country thus gains substantial advantages from stability in the internal value of money.

A country with a stable standard of value also benefits in international trade. Uncertainty in the value of money discourages foreign trade.

Stability in the internal value of money within a country helps to secure external stability—stability in relation to the money of other countries. And this promotes the smooth course and expansion of foreign trade.

(b) *A good currency system should also economise as far as possible the use of metallic money for metallic money is expensive. Paper money is cheap, it is convenient for large payments and also for distant payments; and the relative demands of the public for notes and coins mark the upper limit of the safe issue of notes. The use of paper money within proper limits helps economic prosperity by its superior convenience and also by the metallic money which it liberates from the circulation.*

(c) *A good currency system should also be elastic, i.e., the supply of money should expand with an increase in the demand for currency and should contract with a decreased demand for currency. An elastic currency helps business prosperity by increasing the supply of currency when it is needed and by decreasing the supply when a decreased supply would be good for the community. This elasticity is secured generally by expansion and contraction of note issue and by expansion and contraction of bank credits. Stability in the value of money in a country depends upon its currency system being automatic and elastic.*

And a good currency system is one that commands the confidence of the people. A currency may have important advantages. But without the people's confidence it will not work. This is the substantial practical argument against many of the theoretical schemes of perfection suggested by academic economists and currency reformers. They are too refined and subtle to be believed in and worked by the average citizen—the man in the city street or in the village.

As already described in pages 85, 114 etc., the greater part of the medium of exchange (money in the wider sense) used in any modern country consists of cheques and bank notes. These cheques and bank notes are created with the help of the banking system of the country. So to have a good currency system in any modern country it is essential to have a good banking system and a well-organised and well-managed central bank working a proper standard and maintaining internal and external stability in the value of money.

(Socialists regard the existing distribution of wealth as

unfair to the labouring classes. Orthodox economists, like Marshall and Taussig, though supporting the existing capitalistic and competitive system, are opposed to great inequalities of wealth and income. So good monetary arrangements in a country, while maintaining and stimulating production, should avoid, as far as possible, any losses and hardships to the less fortunate sections of the nation, *e.g.* labourers and the poorer consumers.)

A country with no money and only barter cannot develop exchanges and production beyond the most rudimentary stage as found among the most primitive savages. Modern economic development with its large-scale production, capitalistic methods, domestic and foreign markets, is not possible without a modern system of money.

The essentials of a good banking system.

A good banking system in a country should have satisfactory arrangements and different kinds of banks to provide adequate capital and credit for the agriculture, manufacturing, mining and other industries and internal and international trade of the country. It must make provisions for short-term credit, intermediate credit and long-dated capital.

It should help to stimulate thrift and the saving of capital among the different classes of the nation.

By creating bank notes and cheque currency under proper conditions, it should help to secure good currency arrangements for the country.

Also it should make suitable provision in connection with the government's banking needs and should bring about proper co-ordination between the banking arrangements for the government and for the business interests.

Ordinarily a principal object of a good banking system (as of a good monetary system) is to maintain stability in the internal and external value of the money of the country. For this and for other important services, it is essential that the banking system should be supported by a well-organised and well-managed central bank (or central banks as in the U. S. A.)

working a proper standard and in international co-operation with the central banks of other nations.

(Refer to Central Banks, described in pages 132-135).

Broadly a good banking system should help to promote exchanges, production and ultimately consumption. It should help to organise and stimulate economic progress.

The value of banks—the advantages which a country derives from a good banking system.

Bankers—"potent, grave, and reverend signiors," most of them—earn good profits for themselves and render great services to the economic life of a country. Satisfactory agricultural, industrial and commercial development in any country is possible only with a proper banking system.

A country secures very important advantages from a good system of banking.

(1) Banks economise greatly the use of gold in the exchange of gold. Economy in the use of gold. medium by issuing notes, and also by the cheque system.

(2) Banks collect from thousands of depositors small sums which would have otherwise remained idle or would have been used in unproductive expenditure; and they make these sums available for productive enterprises. This is done by savings banks, investment banks and also by commercial banks. Capital made more productive.

Large investment banks provide ample capital for industrial enterprises and thus help the industrial progress of the community.

The money lent by *commercial banks* is lent for short periods only; but such short-period bank loans *promote the continuity of industry* by enabling manufacturers and merchants to get funds for their operations immediately by discounting their bills instead of waiting for the time when the bills will fall due and be paid by the debtors.

(3) A very important service rendered by banks is this :

***Selection of the best industrial leaders.** They lend freely to capable business men, and in this way the best business men, even when they have little or no capital of their own, are enabled to extend rapidly their business and to become leaders of industry.

Society greatly gains by this increase in the efficiency of industry.

(4) A large foreign trade with a small amount of metallic money is made possible by the foreign exchange operations of banks : and the **foreign trade of the country is facilitated in many ways by a good system of banking.**

The entire industrial and commercial organization of a modern community is intimately bound up with its banking system. The work of production, the internal as well as the external trade of a country, they all depend very largely upon banking facilities.

The stability of banks and their prudent and at the same time enterprising management are absolutely essential to the industrial progress of a country.

✓ **Qualities to be possessed by good bankers.**

"Reputation, reputation, reputation"—this is the cry of the hapless Cassio in Shakespeare's *Othello*. To the banker also reputation is of the first importance. So long as he is able to maintain his reputation, he is able to continue his work of credit manufacture with profit for himself and for the business community in general.

Good judgment about business men and business enterprises and prudence are the qualities required in a banker, engaged in commercial banking. The banker, engaged in investment banking, must have, in addition, courage to

* In Bagehot's expressive phrase, a banker is a kind of *solveny meter*. Some of the wisest heads (i.e. bankers) in England pass their time thinking whether other people will pay their debts.....they lend to people who have business capacity and will be able to repay and thus help the development of industry.

finance new undertakings (factories, mines, railways, etc.), and appropriate managing ability. Sir John Falstaff, the fat old knight, jokingly said that he 'was a coward by instinct' before the true prince. But investment bankers must be courageous by instinct in relation to the princes and kings of industry ; only such investment bankers are able to serve best the needs of industry.

The monetary and banking systems of a country. The World Factor.

It has been pointed out already (Refer to page 100) that at the present day the existence of a good system of money in a country depends upon national causes and also upon world causes. The same is the case with the existence of a good banking system in a modern country.

In the pre-war world with the international gold standard functioning and satisfactory banking arrangements in almost all leading countries, every important country found it comparatively easy to maintain a good banking system. Of course there were difficulties in some periods. But gradually for every leading country a safe and adequate banking system was being developed. The financial (banking) crisis of 1931 spreading from Austria and Germany to Britain and forcing most countries off the gold standard showed clearly once again how the banking system in every important modern country depends upon and is much influenced by banking conditions in other parts of the world. The importance of the world factor in connection with satisfactory banking arrangements in every modern country has got to be sufficiently emphasised.

The nations of the world in monetary as well as in banking matters must become more international-minded, must learn to co-operate more and more with good sense and with genuine goodwill. Otherwise full economic recovery from the world-economic depression and further spells of high economic prosperity will remain as far off as ever. The central banks of the world can perform very useful services in this work of international co-operation.

CREDIT AND PRICES.

What is the influence exercised by credit on prices? Does credit affect price in the same way as is done by money? Or is it done in any other way? And in what way? This is one of the controversial topics of Economic Science. There is a multitude of theories on the subject, and some of the theories are given below.

Credit and Prices.**(1) Credit has no influence on prices.***(a) Walker.*

The general level of prices is determined by the supply of and the demand for the standard medium of exchange. On the level of prices thus fixed, credit transactions occur ; and these *credit transactions* cancel one another ultimately without the use of money, and they *have no influence on prices*.

(Prof. Kinley points out that Walker's view is defective, that there is generally an uncanceled balance of indebtedness based on credit ; and this uncanceled balance creates a demand for money and thus credit has some influence on prices).

(2) Credit influences prices to the same extent and in the same way as money (Mill).*(a) Mill.*

Mill holds that credit is virtually purchasing power, and so credit has the same effect on prices as money.

Mill's theory, however, does not give sufficient attention to the fact that in a credit transaction only half the transaction is completed now, the remaining half being completed only at some later time by the payment of money—so money is required for the completion of a credit transaction. "*In other words, it is a question not simply of purchasing power, but of liquidating power.*" So credit cannot have the same influence on prices as metallic money.

(3) Credit influences prices but not to the same extent as money.

The truth lies midway between the positions of Walker and Mill.

And the correct view may be thus expressed. Money is purchasing power and it is liquidating power to the same extent. Credit is purchasing power, but it is not liquidating power to the same extent. To serve as a basis for credit transactions, a certain quantity of money must be kept as a reserve, and this reserve is withdrawn from the circulation and is not disposable for cash transactions. The credit tends to raise prices by in-

creasing purchasing power and the reserve tends to lower prices by withdrawing metallic money from the circulation. The amount of credit is greater than the amount of the reserve and so the net result is that *credit raises prices to a certain extent* (but not to the same extent as is done by the same amount of metallic money).

Taussig's view.

(a) *In some cases credit-instruments only postpone the use of money* without serving as complete substitutes for money. A purchase on credit has the same *immediate effect* on prices as a purchase with cash. When some purchasers are offering money for goods, and other purchasers are buying goods on credit, the influence of credit is to increase the demand for goods and thus to raise prices. Sooner or later the goods bought on credit must be paid for in money ; and the money that will be used for making these credit payments will not be available for other transactions. In those cases *in the long run* credit has no independent influence on prices.

(b) *In many cases credit-instruments (e.g., bank notes) serve as complete substitutes for money* and affect prices as much as specie would.

*** Crisis.**

Times of difficulty in the industrial situation or the financial situation, when pressure becomes acute, are called crises.

*** Wesley Mitchell on Business Cycles.**

The following brief extracts from Wesley Mitchell, a leading American authority on business cycles, will be of interest to students.

The Discovery of the Problem.

It was not the orthodox economists, however, who gave the problem of crises and depressions its place in economics, but sceptics who had profited by and then reacted against their teachings. From Adam Smith to Mill, and even to Alfred Marshall, the classical masters have paid but incidental attention to the rhythmical oscillations of trade in their systematic treatises. They have been concerned primarily to elucidate principles which hold "in the long run", or apply to the "normal state". To them crises and depressions have been of secondary interest—proper subjects for special study or occasional reference, but,

An industrial crisis means a depression of industry in one or more countries often international in its scope, continuing sometimes for years and producing far-reaching results in the life of the whole community.

not among the central problems of economic theory. To force into prominence the fact that economic activities are subject to recurring phases of contraction and expansion was the work primarily of men who were critics, not merely of orthodox economics, but also of modern society—men such as Sismondi and Rodbertus.

The Theories Now Current.

Among the factors to which the leading rôle in causing business cycles has been assigned by competent enquirers within the past decade are the weather, the uncertainty which beclouds all plans that stretch into the future, the emotional aberrations to which business decisions are subject, the innovations characteristic of modern society, the "progressive" character of our age, the magnitude of savings, the construction of industrial equipment, "generalized over-production", the operations of banks, the flow of money incomes, and the conduct of business for profits. Each of these explanations merits attention from those who seek to understand business cycles; for each should throw light upon some feature or aspect of these complex phenomena.

A Definition of Business Cycles.

Business cycles are a species of fluctuations in the economic activities of organized communities. The adjective "business" restricts the concept to fluctuations in activities which are systematically conducted on a commercial basis. The noun "cycles" bars out fluctuations which do not recur with a measure of regularity.

The phenomena with which business cycles may be confused are (1) changes in business conditions which occur between the dates of "crises", (2) fluctuations which affect a minor portion of the economic activities of a business community, (3) fluctuations which recur every year, and (4) the less definitely established secondary trends and "long waves." From the first of these related species, business cycles are distinguished by the fact that each cycle includes one wave of rising and falling, or falling and rising activity, whereas the intervals between "crises" often include two and some times include three such waves. From the second species, business cycles are distinguished by their wider inclusiveness. From the third species they are distinguished by not recurring annually. From the fourth species they are distinguished by their briefer time-span."—W. C. Mitchell, *Business Cycles*, 1930, pages 3, 4, 11, 12, 468.

Robertson on causes of the Trade Cycle.

"Of the many attempts which have been made to explain the phenomenon known as the Trade Cycle, there are two which appear at the present time to be commanding an ever-increasing measure of assent. According to the one, the main cause of trouble is to be found in the defects of our monetary system; according to the other, in defects

The *financial crisis*, on the other hand, lasts only for a few days or weeks, affects directly bankers and commercial men and is primarily connected with questions of money, banking and credit.

The industrial crisis and the financial crisis are closely connected, they are really two phases of one and the same phenomenon. At a certain stage of the industrial crisis, generally a financial crisis begins and intensifies the situation.

Periodicity of Crises.

The recurrence of crises at regular periodic intervals of 10 or 12 years has been frequently noticed by economists. The idea of periodicity is suggested by an enumeration of recorded years of acute commercial distress in the 19th century—1815, 1825, 1836-39, 1847, 1857, 1866, 1878, 1890.

The doctrine of periodicity of crises was strongly held by Prof. Jevons among other economists. In his famous *sunspot theory* he held that the periodic recurrence of crises is to be explained by the periodic recurrence of sunspots at intervals of 10 or 12 years. Sunspots affect the weather in all parts of the earth and influence the production and prices of corn and other things, and bring about crises. Jevons's sunspot theory has not been widely accepted.

The element of periodicity in crises is exaggerated by certain writers ; but that there is some periodicity is undisputed.

in the judgment and temperament of the leaders of the business world. It seems to me clear that there is a great deal to be said for both of these explanations : but I have never been able to give unqualified assent to either of them, or to any combination of the two. I suspect that the minds of some modern writers are unduly influenced by certain exceptional features of the great post-war boom and slump : I hold that far more weight must be attached than it is now fashionable to attach to certain *real*, as opposed to monetary or psychological, causes of fluctuation : and I am glad to be able to appeal to the pronouncement of Professor Cassel that—

"as long as there is a will to progress, and as long as the material conditions of the satisfaction of this desire require a large use of fixed capital, we must expect a fluctuation in the productive activity of the community akin to the present trade cycles."—D. H. Robertson, *Banking Policy and the Price Level*, Chapter I, Third impression, May 1932, pp. 1-2.

* Causes of Crises.

To indicate the causes of any particular crisis is a difficult task and of course it is much more difficult to formulate a general theory of crises. One writer has counted about 230 explanations of crises and since his time the number has increased.

(I) Ill-adjusted production—an important objective cause.

The industrial crisis is due to a want of adjustment between production and consumption.

This want of adjustment of production to consumption is found in the production of more consumable commodities than can be sold at a profit; the want of adjustment may be found in the making of excessive quantity of new capital e.g., excessive and unprofitable railway construction, or machinery construction etc.

And this kind of mal-adjustment is prominent during times of rapid industrial changes.

(II) Psychological and other Causes. Credit and Crisis.†

Climatic conditions bringing about extensive crop failures, wars and such other things bring about a general depression of industry often culminating into a crisis.

* "Industrial depression due to maladjustment in the division of labour, and especially in the making of new capital. Railways; iron and steel production. The psychological factor; the contagion of business optimism and depression.... During the period of depression, the machinery of production and exchange is out of gear.....Maladjustment in investment; making of new capital beyond the limits set by available savings"—Taussig, *Principle of Economics*, Vol. I., p. 388.

Crisis and Credit.

† "An improvement of credit may have its rise in the opening out of foreign markets after a war, in a good harvest or in some other definite change: but more often it arises from the mere passing away of old causes of distrust, which had their origin in some previous misfortune or mismanagement. Whatever its origin, when once begun it tends to grow. Bankers lend more by book credits, and if they are issuer of notes, they increase their issues. Other businessmen trust their customers readily: bills of exchange multiply: new undertakings are started: orders are given to builders and manufacturers: orders are given for additional machinery and other plant....."

Economists rightly lay great stress on the psychological factor in crises.

This movement goes on for some time, till at last an enormous amount of trading is being carried on with credit and with borrowed money.....The lenders of credit already wish to contract their loans and the demand for more loans raises the rate of interest very high. Distrust increases, those who have lent become eager to secure themselves: and refuse to renew their loans on easy or even on any terms. Some speculators have to sell goods in order to pay their debts: and by so doing they check the rise of prices. This check makes all other speculators anxious, and many rush in to sell.....When a large speculator fails, his failure may cause that of others who have lent their credit to him; and their failure again that of others.....As credit by growing makes itself grow, so when distrust has taken the place of confidence, failure and panic breed panic and failure. The commercial storm leaves its path strewn with ruins.

An adverse movement of the exchanges is often both a symptom and a cause of a slackening of the flow of credit.

..... *The immediate occasion of a commercial crisis* has often been a few business failures, that would have been unimportant if the solid framework of business had not been overlaid by much rather loose credit: but the real cause was not to be found in those small failures. *It lay in the slender hold which much credit at the time had on solid foundations.*" (Marshall—*Money, Credit and Commerce*).

Prof. Taussig notices the two phases of crises: industrial depression and financial collapse (financial panic). During the period of depression, the machinery of production and exchange is out of gear. And he, like Prof. Seligman, emphasises that crises are essentially connected with credit rather than with general overproduction or underconsumption. "The problem which they present relates largely to money, banking, credit; for a solution they point to the improvement of intelligence and the possibility of conducting industry with progress and yet without irregularity. They are little related to those supposed limitations of demand and those possibilities of permanent overinvestment, which are urged by the persons who maintain that there is danger of general overproduction."—(*Principles*, Vol. II, Chapter 41).

Prof. Seligman does not recognise any serious distinction between financial and commercial or industrial crises. And he asserts that a crisis is due not to overproduction nor to under-consumption—it is due to overcapitalisation. "Crises are sometimes classified as financial and commercial or industrial crises. In point of fact, since the bank is the nerve centre of modern business, all crises are financial crises....."

Crises are essentially modern phenomena. They are a product of the new system of business enterprise, built upon capital and credit.During the nineteenth century a certain rough periodicity may be observed in the world crises transmitted from country to country. The important ones were those of 1825, 1837, 1847, 1857, 1873, 1884, 1890, 1893, 1900, 1907 and the war panic of 1914. The surface facts of the phenomena are familiar.....

According to the point of view from which the subject is approached, the explanation usually given is that of overproduction or underconsumption.

During a crisis panic spreads, and so many fail who would not otherwise have failed. Depression in the minds of business men continues even after the objective causes of bad trade have been removed, and so trade languishes. After a time business men recover their spirits. Enthusiasm is catching, trade revives rapidly, till through an excess of sanguine enthusiasm business men rush into overtrading which again brings about a collapse.

A crisis generally begins after a period of business prosperity when prices are high and there is plenty of credit and also plenty of employment for labour. In such a period of prosperity, business expands, new enterprises are launched. Suddenly comes a period of hesitancy and uncertainty.

The new enterprises begin to find obstacles in their way. There is scarcity of money in the bank reserves, the rate of discount rises, and there is a collapse generally precipitated by the failures of some big speculators or bank or banks.

tion. The theory of overproduction states not that there is a general glut of commodities—for that would imply there can be too much wealth, which is absurd—but that there are more goods than can be sold at a profitable price. Whether this overproduction starts with particular commodities and becomes relative overproduction or extends to all commodities and becomes general overproduction is immaterial. The remedy for crises then would be to produce less, either of certain things or of all things. On the other hand, the theory of underconsumption emphasises the inability of the consumer to pay enough to keep the industry going. Were the consumer to save less and spend more, crises might be averted.

The true explanation of crises is somewhat different. The whole problem is one of capitalisation..... A period of good times may be initiated by large orders for some particular business—due, for instance, to a navy programme, to internal improvements, to a war, or to any other large demand. Prices rise in that business, production increases, the movement spreads to other lines, and the new enterprises are financed by loans from the banks or by the sale of the securities of a capitalisation proportionate to the anticipated earnings. The psychological character of these credit transactions is such, as we have seen, that the capitalisation will inevitably be put too high. The hoped-for earnings do not come in an amount sufficient to justify the investment..... The process of readjustment of overcapitalised values necessarily involves loss; but readjustment there must be. If the realisation of its necessity is sudden, we have a crisis or panic; if it can be brought about gradually, we have a process of liquidation.....

Overproduction may indeed accompany overcapitalisation, but the emphasis is to be put on the discrepancy between the investment and the returns. In this sense all crises and depressions are credit phenomena." (Seligman—*Principles*, 1929, pages 543-546).

Then generally comes the acute stage, the financial crisis. The banks are asked to pay cash to depositors and they are asked by commercial men to give them loans to help them in meeting the crisis. Commercial men who are unable to get loans fail, and when the crisis is a very severe one there are several bank failures greatly intensifying the situation. After that comes the period of industrial depression when business is sluggish and few new enterprises are started. The banks gradually accumulate large reserve, the rates of discount become low ; and there is again a revival of industry to be followed by a crisis in cyclic order.

Effects of a crisis.

(1) Beneficial results of a crisis.

The period of depression following a crisis sometimes does substantial good by restoring the proper balance of different parts of the industrial organism ; by checking unhealthy business activity and bringing about better adjustment of production to consumption.

(2) Evils of a crisis and remedies.

Crises have been called diseases of the economic organism.

Crises cannot be entirely prevented so long as we have competitive industry and the credit system. There will be crises and the most that we can do is to mitigate their severity as far as possible.

(1) The integration of industry by making possible better adjustment of production to consumption tends to make crises less frequent and less severe.

(2) It has been suggested that the Government by constructing its public works in periods of depression should counteract in some degree the unemployment due to the industrial depression.

(3) The psychological factor is based on ignorance ; and so this cause of crises can be counteracted to a large extent by wide diffusion of knowledge among business men of the larger aspects of industry and the warnings of the past as embodied in economic history.

(4) As regards the problem of the financial panic, the solution is to have a good currency and banking system with adequate reserves.

The function of a reserve is to be paid out when necessary, a panic must not be starved. During a crisis, a bold policy should be followed as regards the reserve, and the reserve should be paid out in response to calls upon it and the panic will be allayed.

A great central bank with a high standard of duty and following a bold and generous policy in offering loans to solvent banks, merchants and manufacturers, temporarily embarrassed by the crisis, such a bank has been found by experience to be the most effective agency in meeting such a situation. The Bank of England is such a central bank.

The World Economic Depression (1929-) and the Financial crisis of 1931. Causes and effects. (Refer to the last chapter of the book).

Summary.

(1) In a credit transaction, present wealth is exchanged for future wealth, present goods are transferred for a promise of goods to be repaid at a future time

(2) There is not enough metallic money in any country to carry on its entire domestic and foreign trade on a cash basis and there is an extensive use of credit specially in large transactions.

(3) Credit does not create capital but it is a method of production making capital more productive. Other advantages of credit are that it stimulates the growth of capital, and it furnishes a more perfect and convenient means of payment than metallic money for large payments and payments between distant places.

(4) The evils of credit consist in public or private borrowing for extravagant and wasteful consumption and in borrowing for excessively speculative or fraudulent enterprises.

(5) The *instruments of credit* are cheques, drafts, bills of exchange, notes (Bank notes and Government notes) etc.; and the *institutions for organizing credit* are banks and clearing houses.

(6) The fundamental banking functions are borrowing and lending — *a bank borrows to lend*. These functions are performed by the deposit, discount and note issue operations of banks. A bank lends its capital, but its more important function is to *lend its credit*.

(7) Notes issued under the currency principle are secure but in-elastic, notes issued under the banking principle are less secure but more elastic.

(8) There are two kinds of banking systems (1) a centralised banking system with a Central Bank having a practical monopoly of note issue, keeping the ultimate banking reserve of the country, and acting as the fiscal agent of the Government (2) the decentralised system.

(9) The central bank of a country (a) controls the note issue, (b) controls credit, helps, guides and safeguards the other banks, (c) is well fitted for meeting a crisis (d) and offers very considerable advantages to the Government and the economic life of the nation. The Central Bank is the bankers' bank and also banker to the Government,

(10) Banks confer great benefits on society.

They economise the use of gold, make capital more productive, promote the continuity of industry, help in the social selection of the best captains of industry, encourage saving, create a part of the medium of exchange and facilitate foreign trade.

(11) Credit influences prices but it does not exercise the same amount of influence as money.

(12) Crises are periodic and are due to maladjustment of production and consumption. The influence of the psychological factor is important. The relation of credit to crisis is to be carefully noticed.

Questions.

1. What are the different meanings in which the word credit is used?

2. (a) "Credit is capital." Discuss. (C. U. 1923).

(b) What are the advantages of credit and what are its disadvantages?

3. What is a cheque? a bill of exchange? a draft?

4. What are the various functions performed by banks? (C. U. 1923, 1924).

5. Write a note on the clearing system.

6. "Bank deposits in modern times have changed from deposits of cash to deposits of credit." Explain. (C. U. 1927).

7. Explain the banking proposition—loans create deposits. (C. U. 1930).

8. Explain the processes by which banks create credit. What is the effect of credit on prices? (C. U. 1932).

9. Discuss the various factors which influence the discount rate. What is the relation between the discount rate and the general interest rate? (C. U. 1933).

What is the bank rate? (C. U. 1924).

10. Indicate the objects for which bank reserves are held. Discuss the merits of the various ways by which the banks of different countries protect their reserves. (C. U. 1933 and C. U. Hon. 1933).

11. Examine the place of a Central Bank in the currency and banking system of a country. (C. U. Hon. 1930).

12. What is the importance of stabilisation of prices? Discuss the role of banks in maintaining stability of prices. (C. U. Hon. 1930).

13. Explain the function of the Central Bank in maintaining (a) internal stability, (b) external stability in the value of money.

14. Give a short account of the currency principle and also the banking principle.

15. Describe the actual systems of note issue in England, France, U. S. A., Russia.

16. Describe briefly the English Banking system noticing any characteristic peculiarities and special features.

17. Argue the case in favour of a true Central Bank for India. Give your opinion as to whether the true Central Bank for India (a) should be a shareholders' bank, (b) should work the sterling exchange standard, (c) should maintain the rupee at the value of 1s. 6d. sterling.

18. Discuss the nature of credit and consider its influence on prices. (C. U. 1929).

19. Write a note on crisis. (C. U. 1912).

20. What are the essentials of a good monetary system? What are the advantages which a country derives from a good monetary system?

21. State carefully the essentials of a good banking system. Describe the advantages which a country derives from a good banking system.

SOME EXTRACTS FROM THE MACMILLAN COMMITTEE REPORT.

(1) Various classes of Financial Institutions (Banks, etc.) in a modern country.

"But underneath the diversity of functions assigned to the various classes of financial institutions, there may be discerned certain general features which may be summarised as follows :—

(i) Every advanced financial organisation possesses a market in which funds available only for very short periods are lent out. This is designated the *call-loan market*. The immediate effect of an increase in the supply of credit is usually an increased flow of funds to this market, whether, as in New York, it is primarily associated with the Stock Exchange, or whether, as in London, it is primarily associated with the market in bills of exchange, i.e., the discount market.

(ii) Every organised system possesses a market in which the supply of and the demand for *short-period loans* is balanced. To bring short-period lending into relation with short-period demands for accommodation is the primary function of *commercial banks*.

(iii) Every organised system includes a market for the adjustment of the supply of and the demand for *new long-period capital*. This is the *capital market* in the ordinary sense of the term, which prepares and offers new securities to those seeking opportunities for investment.

(iv) In addition, and as an inevitable accompaniment of the capital market, there must be an organisation capable of transferring ownership rights in already existing securities. This organisation is the *Stock Exchange*.

(v) There are usually special organisations dealing with the supply of savings of a special character, or linking up the flow of savings with the demand for savings for special purposes. Into this category fall the insurance companies, the savings banks, agricultural mortgage banks and other analogous institutions.

If the multifarious character of those functions, and of the agencies which perform them, is borne in mind the question of co-ordination naturally arises. How is it possible to attain equilibrium between forces of so diverse a character? In the first instance, of course, equilibrium is attained, as in every market, through the medium of rate or price; if the whole system is in equilibrium, then there will be a definite relationship between the rates of interest or the price of loans in every one of these markets, and between these rates and the expected return on long-period capital. Moreover since the financial structure of every country influences, and is influenced by, the financial structure of other

countries, the whole system of money markets will be in a position of mutually determined equilibrium. Since under an international gold standard international prices tend to a common level; since, further, price movements are influenced by events in the money markets, and the money market is influenced by price movements, a self-determining equilibrium of all the factors, national and international, is attainable, given a sufficiently long period of time, and the absence of disturbing causes. Thus variations in the rate of interest charged appear to be the appropriate instrument to bring about harmony."

(2) The International Gold Standard.

Refer to pages 18-24 and to pages 108-110—Macmillan Report, also pages 81-84 of this book.

(3) Main Objective of Central Banks to Maintain Stability.

The main objective of Central Banks acting in co-operation in the management of the international gold standard should be to maintain the stability of international prices both over long periods and over short periods—i.e., they should both keep the average steady over a period of years and avoid fluctuations round this average from year to year. Or alternatively—if this alternative were to receive superior support—they should prevent prices from falling to a greater extent than is justified by the increase in the efficiency of production. Stability over long periods is largely a question of the adequacy of the quantity of gold available for their reserves taken in conjunction with the proportionate volume of credit created on this basis; stability over short periods, or in other words the mitigation so far as possible of the Credit Cycle, is we believe, largely a question of co-operative monetary management."

(4) The Bank of England.

(a). The Bank of England Note Issue.

As regards the right principle for regulating gold reserves in the changed circumstances of to-day, we may, without entering into a long argument, summarise our views very briefly as follows :—

(i) If it is thought unnecessary to fetter the discretion of the Bank of England in regard to the volume of its deposits, which in a modern system is the significant and operative factor, there can be no good reason for fettering very narrowly its power to issue notes.

(ii) There are great advantages in a high degree of mobility for the gold reserves of Central Banks. For the task of reconciling international exchange stability with domestic credit stability will be made much easier if the Central Bank is free on occasion to allow wider

fluctuations in the proportion of its total assets which is made up of gold and comparable items. It is also desirable that the public should become accustomed not to attach undue importance to fluctuations which the Bank has deliberately permitted.

(iii) In present circumstances it is highly desirable that throughout the world the disadvantages of the immobility of gold, and of laws whereby a very high proportion of the world's total stock of gold is rendered sterile, should be modified, and we should not maintain any legislation which conflicts with this aim.

(iv) Nevertheless, it is not unreasonable to regard some part of a country's gold reserve as not belonging to the Central Bank's *masse de manœuvre* for normal daily uses, but as an ultimate reserve, not to be brought into consideration in ordinary cases, but kept as a last resort for use only on grave national occasions and after special deliberation between the Government and the Bank. Such a reservation can be justified both by its effect on confidence and in itself.

(v) The proper amount of this ultimate reserve cannot be reached as a fixed proportion of the note circulation (which is the usual principle abroad) or as the excess of the note circulation over a fixed figure (which is the principle of British fiduciary issue). For it depends on quite different factors from those which determine the note issue. A change, for example, in the habits of the public in paying by note or by cheque respectively cannot affect the appropriate amount of the gold which we hold against emergencies.

... . The best form of limitation on the discretion of the Bank of England in regard to the volume of its note issue, is, we think, the system which prevailed in France for many years before the War, namely, an absolute maximum subject to modification from time to time by law or by Treasury Minute.

We consider, therefore, that the best means of regulating the note issue and the gold reserves of the Bank of England would be the following:—

(a) That Parliament should give the Bank of England power to put into circulation notes to an amount exceeding by a moderate figure what has been found by experience to be the normal note circulation. Thus if we take the seasonal maximum of the present note circulation (exclusive of notes in the Banking Department) at £380,000,000, the absolute maximum beyond which the Bank of England must not go might be set at £400,000,000, this figure being subject to modification by law from time to time. Provision should also be made for additional temporary elasticity by permission of the Treasury on application by the Bank of England similar to the provision in the Act of 1928.

(b) That the Bank of England should by law not be permitted to allow its gold reserve to fall below (say) £75,000,000, except temporarily by permission of the Treasury in accordance (again) with a procedure similar to that laid down in the Act of 1928. In proposing this figure

as a *statutory* minimum we do not contemplate that the Bank of England would actually allow its gold to fall so low in any ordinary circumstances.

We should add at once, to prevent misunderstanding, that we are not in favour of a reduction in the Bank of England's normal stock of gold. So far from this being the case, we recommend in para. 354 below that Bank's normal holdings of gold or its equivalent in foreign-exchange should, in view of the large liability of London as an international banking centre, be larger than they have been in recent years. What we envisage therefore in the future is a Bank of England with both increased resources and greater freedom. It is necessary, however, to say that freedom and willingness if occasion requires, to export gold in considerable amounts presupposes power also to draw it back from abroad in case of need. This again presupposes that this country maintains a sound position in respect both to its Government finances and its balance of payments."

(b) *The Separation of the Departments.*

"On more general grounds we see no advantage in the separation of the departments. It is confusing and misleading to any one who is not an expert. In particular the Bank's so-called "reserve" and its so-called "proportion" have quite different meanings from those attaching to these terms elsewhere and lend themselves to erroneous comparisons with other institutions and to an under-rating of the real strength of the Bank of England. It is inconceivable that anyone settling the matter afresh to-day would devise the present form of statutory return. Moreover, if our recommendations made above for the future regulation of the note issue and the gold reserves are adopted, the separation of the departments must necessarily come to an end."

(c) *The Relations of the Bank of England with the Joint Stock Banks.*

"In the United States the member banks of the Federal Reserve System are required by law to maintain balances with their Reserve Bank bearing a specified relation to their deposits. . . .

In Great Britain there are no legal requirements.

We recommend that the London clearing banks should aim at the maintenance on the daily average of each three-monthly period of an amount of cash in bank notes and balances with the Bank of England of not less than 10 p.c. of their deposits.

For banks other than the London clearing banks, we have not available the statistical information necessary to make a definite recommendation as to their cash balances.

We have already expressed the opinion that the resources of the Bank of England ought to be augmented with a view to increasing both the amount of its own liquid reserves and the amount of its earning assets available for various types of open-market operations.

The adoption of these recommendations would provide some increase in the resources of the Bank of England. But it would not, we think, provide a sufficient increase in view of the considerations which we have urged above. We suggest, therefore, that the Bank of England should consider an appropriate increase in the amount of its capital."

(d) *Proposal relating to the Capital Market for Home Investment.*

"Each great financial centre has its own characteristics. But the City of London can still claim to be the most highly organised international market for money in the world. Its freedom and elasticity are without parallel. . . .

It is noteworthy, however, that, speaking generally, the exceptional merits of the City of London lie in the facilities given by the short-term money market for the employment of home or foreign funds; in the financing of trade and commerce, also both home and foreign; and in the issue of foreign bonds, as distinguished from the financing of British industry. The combined facilities offered by the accepting houses and the discount market have for very many years been made use of by bankers, merchants and traders throughout the world; they have been equally available to, and have in fact been largely made use of by British merchants and traders. In so far as these facilities have not been even more largely made use of by the latter, the reason must lie in the fact that they have been able to find all the credit they wanted as cheaply or even more cheaply from the joint stock banks themselves. *But the relations between the British financial world and British industry, as distinct from British commerce, have never been so close as between German finance and German industry or between American finance and American industry.*

Taking first the very broadest view over the modern world, we believe that in any community which wishes to keep in the van of progress the financial and industrial worlds should be closely integrated through appropriate organisations. . . .

In a second direction we see advantages in a closer co-operation of industry and finance. It is all-important to the community that its savings should be invested in the most fruitful and generally useful enterprises offering at home. . . .

While from the investor's point of view there would be undoubted advantages in a closer connection between British industry and the City of London, we think that the financial community and industry would both benefit. We believe it not unfair to say that certainly in American and German banking circles, and possibly in French also, there would be found many more men with an intimate knowledge of the problems of industry than in England. . . .

. . . . In general we are satisfied that, subject to the conditions imposed by the necessity of accommodating ourselves to the outside world, *our banking system is adequate and satisfactory in the provision of the normal short-credits to industry and their distribution.* . . .

There are two other questions; whether our financial organisation is as fitted as it might be to supply industry (i) with intermediate credit and (ii) with long-dated capital.

Intermediate credit may be defined generally as credit advanced for periods ranging from one or two up to five years. It is necessary, we think, to divide into at least three main classes the types of transactions for which intermediate credit is required, namely: (i) hire purchase or instalment sales, (ii) advances against deferred payment, (iii) long-term contracts. . . .

Coming back now to the more general question of the relations between finance and industry, and in particular to the provision of long-dated capital, we believe that there is substance in the view that the British financial organisation concentrated in the City of London might with advantage be more closely co-ordinated with British industry, particularly large-scale industry, than is now the case; and that in some respects the City is more highly organised to provide capital to foreign countries than to British industry. . . .

It would seem desirable, therefore, that the Bankers' Industrial Development Company should at a convenient stage be definitely separated from the Bank of England, have an independent existence, and rely upon its profit-making capacity as a private institution. It is possible that it might form a nucleus for that closer co-operation between finance and industry which we think is required.

There is no reason why the field should be limited to any one institution. . . ."

CHAPTER III.

International Trade and Foreign Exchange.

International trade, as its name implies, is trade between nations ; and it is to be distinguished from home trade, *i.e.*, commercial dealings taking place within a single country.

Is there a separate theory of international trade (as distinguished from the theory of home trade) ?

Home trade results from division of labour and secures large economies from this division of labour and benefits all parties concerned." International trade also does this only on a more extended scale and embracing many nations and is thus, in important respects, similar to home trade.

There are however real scientific grounds for having a distinct theory of international trade. *The real reasons why there is a separate theory of international values as distinguished from the theory of home values is that labour and capital flow much less readily between country and country than between different parts of the same country. Labourers do not move freely from their country to another country—the ties of nationality, language, religion, and also poverty, ignorance and want of enterprise hold the vast majority of people to the land of their birth. Internationally, capital though not so immobile as labour still possesses a considerable amount of immobility. Most people like to invest their capital in their own countries, and are comparatively unwilling to invest abroad.*

Differences in the monetary systems of different countries, differences in the regulations made by different Governments for controlling international trade, and cost of carriage from one country to another—these are all factors, each to be noticed, in a complete theory of international trade.

* International values.

The theory of international values deals with the question—what causes determine the proportions in which trading nations exchange their products (*Cairnes*).

In other words *how are international values, (the values at which goods exchange in international trade) determined?* The solution of this problem is to be found by a proper application of the fundamental principles of demand and supply which apply to all cases of value.

While discussing the values of commodities within the same country we assume that labour and capital are mobile and move freely from one part of the country to another ; and the *normal value of a commodity within a country* under these circumstances is determined by its cost of production within the country.

In discussing international values (as distinguished from values of commodities within the same country) we assume that products move from one country to another but that labour and capital do not move so freely from country to country.

* This is the theory of the English writers as developed by Ricardo, Mill and Cairnes. Prof. Edgeworth accepting Ricardo as the founder of the theory asserts that 'Mill's exposition is still unsurpassed'.

The English theory has not been widely accepted on the continent. Prof. Seligman, a noted American writer, makes the following observations in connection with the theory of the English economists :

"It was long supposed that the principles of international trade differed from those of internal commerce, in that the former was subject to the law of comparative cost and dependent on the existence of non-competing industrial groups. We now know that the law of comparative costs or of reciprocal demand is the explanation of all exchange and that non-competing industrial groups are found in internal industry as well. *Trade takes place between nations as between individuals, because of relative, not of absolute advantages.* One country A may produce a certain class of commodities at a lower cost than B and nevertheless find it profitable to import them, because A can produce other commodities still more cheaply than B. It will be advantageous for A to export the second class of commodities and to receive pay for them by importing the first. *The entire body of economic doctrine elaborated by Ricardo, Mill and Cairnes, tending to show that international trade rests on the equation of reciprocal demand and comparative cost, has no distinctive application to international exchange and therefore calls for no special discussion here.*"—(*Principles*, Chapter xxxii).

This international immobility of labour and capital gives the key to the theory of international values.

Let us begin with a simple case. Let us assume only two countries, England and France, engaged in international trade ; and they are carrying on an international trade in two commodities only *viz.*, silk and woollen goods.

The relative cost of production of silk and woollen goods in France differs from the relative cost of production of silk and woollen goods in England, and this difference is due to the fact that labour and capital do not move freely from England to France and from France to England.

And it is the difference in comparative costs which leads to international trade. **International trade begins between any two (or more) nations as soon as there is a difference in comparative costs.** Let us see how the thing works.

Suppose in France the same cost will produce 15 yards of silk or 16 yards of woollen goods.

And suppose in England the same cost is required for producing 15 yards of silk or 20 yards of woollen goods.

England (as compared with France) has the greater relative advantage in the production of woollen goods ; and France (as compared with England) has the greater relative advantage in the production of silk goods—so England will produce woollens and France will produce silks, and England will get from France the silks she wants in exchange for her woollen goods.

A country tends to export things in the production of which it has a comparative advantage, and it tends to import things in which it has a comparative disadvantage.

(i) *International values of woollen goods and silk will lie between the limits imposed by comparative costs** ; the ratio at

* Note that in comparing costs we compare not the costs of production of the same commodity in the two countries, but that we compare the costs of production of the two commodities (silk and woollen goods) in England and we compare the costs of production of the same two commodities in France. The costs of commodities (forming the subject of international exchange) within the same country are compared.

Also note that there is the assumption that silk in France and woollen goods in England are produced under conditions of constant return.

which England will exchange woollen goods with silk from France will be between

15 yards of silk=20 yards of woollen goods (comparative cost of silks and woollen in England).

15 yards of silk=16 yards of woollen goods (comparative cost of silks and woollens in France).

(ii) Suppose under certain circumstances, the ratio of exchange between the two countries is 15 yards of silk=16½ yards of woollen goods. With an increase in the demand for silk goods in England, England will be willing to give more woollen goods in exchange for each 15 yards of silk—the rate of exchange may become 15 yards of silk=17 yards of woollen goods or 15 yards of silk=18 yards of woollen goods etc., according to changes in demand for woollen goods in France and for silk goods in England.

Within the limits imposed by comparative costs, the particular ratio of exchange between the commodities is thus determined by the intensity of reciprocal demand in the trading countries.

The ratio of exchange must be such that in the long run the total values of woollen goods and silk goods exchanged must be equal.

In our illustration we took only two nations and two commodities for the purpose of making clear the essential principles involved.

Now we enlarge our figure to life size. In actual practice, we have trade not between two nations but between many nations; and the commodities which are exchanged in international trade are also numerous. But trade among any number of nations and in any number of commodities must take place on the same essential principles as trade between two countries and in two commodities.

But the two commodities exchanged may be different and may be subject to diminishing or increasing return. Also there may be non-competing groups within the same country. For the influence of such factors in the theory of international value, refer to C. F. Bastable, *Theory of International Trade*, Chap. II and F. W. Taussig, *International Trade*.

To sum up :

International trade results from differences in comparative costs due to international immobility of labour and capital.

(i) *International values (the ratios of exchange between commodities entering into international trade) are determined by the intensity of reciprocal demand within the limits imposed by comparative costs.*

(ii) *The ratios of exchange must be such that the aggregate value of the exports of a country must equal, in the long run, the aggregate value of the imports.*

A paradox and its explanation.

An interesting and apparently paradoxical conclusion follows from the principle of comparative costs. *A country may import things in which its labour is more effective than is the labour in the country whence they come.*

The United States can make linens more cheaply than Germany or Ireland, and can make flax fibres more cheaply than Belgium. The United States do not however produce linens and flax fibres, but import them from Germany, Ireland and Belgium. The reason is this. The United States, though possessing an advantage over these countries in the production of flax fibres and linens, possess greater advantages in the production of other commodities ; and so the country will devote itself to the production of those goods in which its superiority is greatest and will exchange these goods for other imports in the production of which its superiority though real is not so great.

Barter and money theories of international value.

In discussing international values, English economists generally regard international trade as the barter of commodities. This is the method followed by J. S. Mill and Cairnes, and also Marshall, Bastable and Edgeworth.

In his *Principles*, Vol. II, Nicholson has preferred to treat international values in terms of money. For the comparative merits of the barter and money theories, refer to Bastable's *Theory of International Trade* (Appendix C).

Sidgwick's theory of international value as dependent on cost of carriage.

Sidgwick's theory of international value is different from the current theory of international value as held by Bastable, Marshall and other prominent English economists. The current theory is that the peculiarity of international value depends upon the imperfect mobility of labour and capital between different nations; but Sidgwick maintains that international value depends not primarily on the imperfect mobility of labour and capital but on the cost of carriage. In international trade there is a double expense of (a) sending the commodities out of a country and (b) importing other commodities in payment for these exports; and according to Prof. Sidgwick the problem of international value consists in the determination of the conditions governing the division of this cost of carriage between the trading nations.

Objection against Sidgwick's theory.

As against Prof. Sidgwick's view, there is the fundamental objection that his theory seeks to determine the division of only one kind of loss (*viz.* cost of carriage) in international trade; and it furnishes no solution of the division of other losses in international trade.

Cost of carriage. Import and Export Duties etc.

The introduction of cost of carriage and also of import and export duties makes the problem of international trade more complicated; but it does not alter its essential character. *To be quite accurate and comprehensive, we must say that trade begins between two nations when values differ after cost of carriage and tariffs (import and export duties) have been allowed for.*

Cost of carriage, import and export duties and other hindrances to exchange reduce the advantages of international trade.

Cost of carriage if high enough will prevent international trade. Ordinarily it raises the value of a commodity in the importing country to a certain extent. *The division of the charge for transport will depend on the readjustment of demand which the change in values will probably produce.*

The advantages of international trade.

In The Merchant of Venice the famous speech of Portia describes mercy as "twice bless'd";

It blesseth him that gives, and him that takes."

International trade is also twice blessed. It is of advantage to (1) the importing country, (2) the exporting country.

I. • Economic gains.

The benefits of international as of all exchange lie in an increase of utility to the exchangers.

With a given amount of effort, a nation gains a larger satisfaction by means of international trade than it would get in the absence of such trade.

As regards imports.

(1) International trade enables a country to obtain by importation articles which cannot be produced at home. It is in this way that Switzerland gets coal and all European countries get tea, coffee, tropical fruits.

(2) Another advantage of international trade is that it enables a country to get by importation commodities which could be produced at home, only at a greater cost.

England gets by importation wine and silk much more cheaply than she could have produced at home.

(3) By importation, a country is able to save itself from the grip of famine and scarcity when its own crops fail.

(4) International trade acts as a powerful check on domestic monopolies and trusts, and it prevents rapid fluctuations of prices.

• "Foreign trade, then, though highly beneficial to a country, as it increases the amount and variety of the objects on which revenue may be expended, and affords, by the abundance and cheapness of commodities, incentives to saving, and to the accumulation of capital. . . .

Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each. This pursuit of individual advantage is admirably connected with the universal good of the whole." (Ricardo—*Principles of Political Economy*, Chap. vii).

"In broad terms it may be said that the *prima facie* and direct gain which a country derives from her foreign trade consists of the excess of the value to her of the things which she imports over the value to her, of the things which she could have made for herself with the capital and labour devoted to producing the things which she exported in exchange for them; the costs of working the trade being of course reckoned in." Marshall—*Money, Credit and Commerce*, Book III, Ch. II.

As regards exportation.

(5) A country superior to another in many branches of production, will devote itself to the production and export of commodities in which its superiority is the greatest, and it will import the other commodities. In this way *international trade will raise the productive efficiency of a nation to its maximum ; it will develop the nation's industries.*

(6) International trade by creating world-wide markets greatly extends division of labour and large-scale production. It makes each nation devote itself to those industries for which it is best fitted by its natural resources and aptitudes of the people ; and so the *productive efficiency of all nations is greatly increased and the world, as a whole, gains.*

II. Non-economic gains (social, moral and political advantages).

(1) International trade brings men of one nation in touch with the men of other nations possessing different types of culture and civilization ; and this leads to social, moral and political progress.

(2) Commerce is binding the different nations of the world by common economic interests. And so it has been maintained by many writers that international trade diminishes the chances of war, and the development of international commerce is one of the best guarantees of universal peace.

The last great world war shows, however, that the extinction of war by the development of international commerce is yet very far off from realisation.

Disadvantages of international trade.

The possible disadvantages of international trade to a particular country, are on a large scale but are practically of the same nature as the disadvantages resulting under certain circumstances from division of labour within the same country.

Importation has its dangers.

(1) A sudden introduction of foreign trade and the influx

of huge quantities of foreign imports will upset the industrial organisation of a country. Labour and capital already engaged in some industries thus subjected to very strong foreign competition, may find it difficult for some time to transfer themselves to other industries. Some part of the *capital may be lost*.

The labourers engaged in the industries, ruined by foreign competition, *lose their employment* and suffer as they will not be able all of them to get other employment quickly.

(2) The consumption of certain commodities (e.g. opium, cocaine, certain kinds of liquors, etc.) affects very injuriously the physical and the moral welfare of the consumers; and the importation of these commodities is an evil of serious magnitude.

Some dangers on the side of exports are the following:—

(3) *The specialization of industries*, resulting from foreign trade increases the chance of so-called overproduction.

When a country has an industry producing and exporting for a world-wide market, it is difficult to calculate exactly the amount that would be demanded in such a market—
 a war or any other grave disturbance of economic conditions may bring about a sudden decrease of demand, which will produce serious results.

(4) The exportation of food-stuffs and other agricultural products may under certain circumstances intensify the action of the law of diminishing returns in agricultural countries.

(5) When the product is an exhaustible one (like English coal or Peruvian guano), the evil is more apparent. A not inconsiderable part of British industrial strength is based upon Britain's superb coal resources and an excessively

rapid exhaustion of her coal mines may conceivably imperil British industrial supremacy.

*** Balance of trade. Balance of accounts.**

(The expression 'balance of trade' indicates, in popular language, the relation between imports and exports of commodities. We see from an examination of the statistics of international trade that the imports and exports of a country are rarely equal. In England, in France, and in some other old and rich countries the imports of goods exceed the exports and such countries are said in popular speech to have an unfavourable balance of trade. In Australia, in India the exports of goods exceed the imports; and countries having such an excess of exports are said to have a favourable balance of trade.†)

*** The mercantilist ideas about foreign trade and balance of trade.**

The terms favourable and unfavourable balance of trade are relics of old mercantilist theory. The mercantilists held that the principal object of foreign trade was to import precious metals from foreign countries. A country exporting more goods than it imported would according to the mercantilist theory get a quantity of precious metals in exchange for the excess exports, and so an excess of exports was regarded by them as a *favourable balance of trade*; conversely a country importing more merchandise than it exported would, according to the mercantilists, have to export precious metals to pay for the excess imports, and so an excess of imports was regarded by them as an *unfavourable balance*.

The mercantilist beliefs (1) that money is the best form of wealth and (2) that the object of foreign trade is to bring about importation of precious metals—these beliefs are now rejected by modern economists. (3) Again the mercantilists are wrong in maintaining that an excess of imports has to be paid wholly by exportation of metallic money. It is paid partly or wholly by other and more convenient means; and a country does not always get metallic money for the whole value of its excess exports of goods because it may have debts which it may pay wholly or partly by its excess exports of goods.

† The so-called 'favourable balance of trade' is extremely misleading

(1) It is popularly thought that a country with a 'favourable balance of trade' is necessarily prosperous. This is not so. A country with a favourable balance of trade may or may not be prosperous. Some poor countries, like India, Siam and Peru, have the so-called 'favourable balance of trade'; and some rich countries, like Britain and France,

(When we want to find out whether the foreign trade of a country is in equilibrium (i.e. whether its total credits and debits are equal) we have to consider not merely the exports and imports of goods and *balance of trade* resulting from these imports and exports, we have rather to consider the *balance of accounts* resulting from the total credits (claims) and debits (debts) of a country. The total credits of a country include exports of goods (by which the country becomes the creditor of other countries) and many other things; the total debits of a country include imports of goods (by which the country becomes debtor of other countries) and many other things. The balance of accounts (or the true balance of international payments) resulting from the total debits and credits of a country is something quite different from the so-called balance of trade resulting merely from exports and imports of goods.)

The credits and debits of a country.

Important international claims and debts rise also in other ways than by exports and imports of goods recorded in official government statistics, and are known as *invisible* exports and imports*. These invisible exports and imports (of goods and services) though not included in the balance of trade, must be taken into account when we want to find out the true balance of international payments.

The following are the principal debits and credits of a country:

(1) *Exports and imports of goods.* A country becomes the creditor of another country by what it exports, and it becomes a debtor by what it imports. India exports generally more goods to England than it imports from England; on this account India is a creditor and England a debtor.

have the so-called 'unfavourable balance of trade' (See *The significance of an excess of imports and an excess of exports*, pages 217-218).

(2) There is an important difference according as the cost of transportation is or is not included.

* These exports and imports are called invisible not because they cannot be seen—often they can be seen well enough, they are tangible. They are called invisible because they are not recorded in the official figures of trade.

(2) *The interest on capital invested abroad.* Rich nations invest considerable amounts of their capital in other countries and they get interest.* England gets every year very large sums in this way as interest on foreign investments and is a creditor; and in this respect India, Egypt, Australia, etc., appear as debtors.

(3) *The cost of transportation of goods by ships, etc. (i.e., freight and insurance).* England on this account gets very large sums from India and foreign countries—so England is a creditor, and India is a debtor; and these services of transportation are an invisible export in the case of England.

(4) *Bankers' commissions, etc.*

Countries (like England, France) with bankers doing agency and financial work for merchants of foreign countries become creditors of these foreign countries for bankers' commissions. On this account also England is a creditor, and India is a debtor. Such banking services form an invisible export of England, and an invisible import of India.

(5) *Expenses of foreigners living or travelling in a country.* Countries like Switzerland and Italy, which are visited by tourists in large numbers, get from them large sums as their expenses, India also gets certain sums in this way. Again India has to pay large sums to foreign countries as expenses incurred by Indians studying, living or travelling in these countries.

(6) *Government expenditure in foreign countries for diplomatic service, tributes, war indemnities, borrowing and repayment of loans or the purchase of securities—they all must be included in calculating the true international balance.*

India has to pay every year the 'Home Charges' to England on account of interest, and also pensions and leave pay of English officers and for Government stores, etc.; in this matter England is a creditor, and India is a debtor.

So the complete statement is that *the goods, monies and services, rendered by one country to other countries plus its credits and claims of all kinds, will be balanced by the goods,*

* "British foreign investments which now amount to some £3,500,000,000 are likely in future years to increase rapidly beyond that figure." (Hobson—*The Export of Capital*).

monies and services, received by the same country plus its obligations and debts of all kinds. It is in this sense that the total debits and credits of a country are equal—and in the long run.

Imports and Exports tend to be equal.

The proposition that imports and exports of a country must be equal is not true in the sense that the imports of commodities into a country must equal in value the exports of commodities. England has an excess of imports. India has an excess of exports.

A country may pay for the goods imported from another country by goods—and also by services. We see that equilibrium is attained when the total credits of a country balance its total liabilities; and such an equilibrium may be perfectly compatible with an excess of exports or an excess of imports (of commodities).

*The proposition is, however, true in the sense that in the long run the total credits of a country must equal its total debits. For in the long run, every country must normally pay its debts.**

Significance of an excess of exports, and of an excess of imports.

An excess of imports of commodities into a country may mean (a) the incurring of liabilities to other countries or (b) it may, on the contrary, mean liquidation of past and present indebtedness to that country by other countries. An excess of exports may mean (a) that one country is making other countries its debtors by this excess of exports, or (b) it may mean that the country by the excess exports is paying other countries interest on capital borrowed from them or remuneration for services rendered by them.

* As Prof. Bastable puts it "The establishment of the equation of indebtedness is for every country what Cairnes declared it to be for the United States—'simply the condition of her remaining a solvent nation.'" (*Theory of International Trade*, Chap. IV).

The annual excess of exports of commodities from India means the latter thing. These excess exports enable India to pay interest on English capital borrowed by India and also to pay England for political and other services rendered by Englishmen, the services rendered by English officers, English shipping and English bankers and so on.

* Foreign Exchanges.

The expression "foreign exchanges" is used to mean different things.

(1) The expression is sometimes used to mean *foreign bills of exchange*. When we say that the Exchange Banks of India buy and sell foreign exchange we mean they buy and sell foreign bills of exchange.

(2) Somestimes the expression 'foreign exchange' is used to mean the *rates of exchange*, at which foreign bills are sold. When we say 'the foreign exchanges' are moving against a country we refer to the rates of exchange.

(3) *The mechanism of payment in foreign trade is known as the Foreign Exchanges.*

"The machinery whereby payments are effected in foreign commerce is known as that of the foreign exchanges"—(Chapman). Payment is made chiefly with bills of exchange, running for certain periods or with cheques which may be regarded as bills payable at sight.

The subject of Foreign Exchanges is treated in this book generally with reference to ordinary conditions (does not take note of violent disturbances caused by a great war or a general collapse of credit).

* "Foreign Exchange means the buying and selling of the money of other countries and is handled in the same way as the buying and selling of most other things. . . . In other words, Foreign Exchange is the Science and Art of international money changing" (Withers—*Money-changing*).

So the expression "Foreign Exchanges" is used to refer to (1) the thing (i.e. the foreign bill of exchange) bought, or (2) the price at which it is bought, or (3) the institutions and machinery through which the thing is bought.

Economising of metallic money in foreign trade.

Even in the home trade, the use of metallic money being expensive and also inconvenient for some purposes a very large proportion of payments is made through paper credit devices ; and the use of metallic money is economised to a very considerable extent. The same thing happens also as regards the foreign trade of the country.

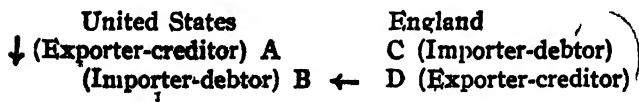
The expense and inconvenience of sending metallic money from one country to another for making international payments have led to a wonderful economy in the use of metallic money in making payments in foreign trade.

As compared with the enormous values of goods exchanged in international trade, *only a small amount of money is used ; the greater part of the payments is made through transfer of obligations largely by paper instruments called bills of exchange etc.*, money being employed only for the occasional settlement of the balances remaining after the cancellation of credits and debits.

The operation of a bill of exchange. A bill pays two debts.

How are these bills of exchange used to make payments in international trade by the transfer of obligations?

To understand this, let us see the operation of a bill of exchange between two countries, say the United States of America and England.



A and B are two merchants in the United States of America ; C and D are two merchants in England. Suppose A (an American exporter) has sold goods worth £1,000 to C—A has sold goods and has drawn a bill for £1,000 upon C representing his claim against C. A in America is thus creditor of £ in England to the extent of £1,000.

Also suppose that D (an English exporter) has sold goods worth £1,000 to B. D (an English exporter) is thus the creditor of B in America to the extent of £1,000.

Now the bill will move in the way shown by the arrow marks in the figure given above.

A will sell that bill for £1,000 and in this way he will recover the value of the goods sold by him ; *A will thus be paid.*

B will buy the bill from A because B has to pay £1,000 to D for goods bought by him from D. B will send this bill for £1,000 (drawn by A upon C) to D ; and *D will recover the value of the bill from C.* In this way B's payment to D will be made by using the bill drawn by A upon C.

We thus see that *using the bill of exchange drawn by A upon C, (1) A's claim against C is paid (2) also D's claim against B is paid. Every bill pays two debts.* If there were no bills of exchange, then C would have to ship metallic money from England to America to pay A and B would have to ship metallic money from America to England to pay D. This *double shipment of money and the expense and inconvenience attaching to it are avoided by the use of the bill of exchange,* and B's transferring to D the bill representing C's obligation to A.

Of course in actual practice, a bill does not operate exactly in this way. Still this serves to illustrate the principle.

In America there are thousands of exporters and importers and there are thousands of exporters and importers in England. *Bills to the value of many millions will be drawn by American exporters upon English importers and will be bought by American importers to pay their English creditors (English exporters) ; and through the use of these bills a great economy in the use of metallic money will be effected in making international payments.*

[An American importer will often make his payment to the English exporter by buying the draft of an American bank on a bank in England and by sending the draft to his English creditor. Also in other ways. As Prof. Marshall

points out 'The part which bills play in foreign trade is steadily-diminishing' (*Money, Credit and Commerce*).]

*"The exchanges in question are exchanges of claims or debts."**

The payments in international trade between two countries. (say England and America) will very largely be made through

Balancing of credits and debts between two nations.

the balancing of mutual debts and credits by bill of exchange etc. ; and metallic money would be required only for the payment of the balance remaining after the balancing of credits and debts.

† *A further economy of metallic money in foreign trade is effected. The method of payments by balancing accounts is*

Further economy of metallic money effected by the balancing of credits and debts between many nations.

confined not to two nations but is in operation among all industrial and commercial peoples. Suppose America owes England five million pounds after the balancing of accounts and if America

is at the same time a creditor of another country to the extent of five millions after balancing accounts with that country, then obviously America can pay her debt to England by transferring America's claim against the third country to England.

When we consider all nations trading together, the total credits of a nation against all other countries are utilised to pay its total debits to all other countries by the use of bills of exchange, drafts etc. ; and if the total credits are less than the total debits, then the country has to pay metallic money for the excess debits, or it has to continue in debt.

Some terms and explanations.

Bills of Exchange, foreign bills, sight bills, long bills, etc.

† Bills of exchange, as already explained in the chapter on

* Goschen—*Theory of the Foreign Exchanges*.

† "If England has large payments to make to America, which has large payments to make to China, which has large payments to make to England, England is likely to discharge part of her obligations to America by bills on China : These round-about operations are among the chief economies effected by the exchanges" (*Marshall—Money, Credit and Commerce*).

'Banking,' are drawn by merchants and manufacturers upon persons to whom they have sold their goods; and these bills represent the claims of these merchants and manufacturers against the persons to whom they have sold their goods.

The *drawer* of the bill is the person who draws the bill, the creditor to whom the money is owing: and the debtor, who owes the money is called the *drawee*. When the debtor signs the bill to signify his acknowledgement of the debt, he is said to *accept* the bill.

Bills of exchange are divided into (1) *Inland bills* of which the drawer and the drawee live within the same country.

(2) *Foreign bills of exchange* of which the drawer and the drawee live in different countries. In the chapter on 'Foreign Exchanges' we shall have to deal with these foreign bills of exchange. We must also note the difference between a *sight bill*, which is a bill payable by the drawee at sight and a *long bill*, which must be immediately accepted by the drawee and paid after a prescribed period, say 30, 60 or 90 days. A bill is said to be *discounted* when it is sold to a third person for its present value, the third person deducting from the future value of the bill something as interest.

The bankers are *middlemen* as regards the purchase and the sale of these bills. From whom do the bankers buy these bills? The bankers buy the bills from persons who have sold goods abroad and have drawn bills of exchange upon these foreign purchasers. The bankers purchase the bills from these exporters; and they sell the bills to the importers who pay their foreign creditors with these bills.

Bill drawn on persons in London and payable in London are called *paper (bills) on London*. Similarly we have *paper on New York, or on Paris*.

* The bill on London.

The great mass of bills is to-day drawn on London in pounds sterling, (exchange payable in London in pounds

* 'Why is it that in the East Indies, those who ship produce to America draw on London not on New York; and why the New Orleans cotton exporter draws on London instead of on St. Petersburg for the cotton shipped to Russia? A partial cause might be found in the credit

sterling is called *sterling exchange*). This is due chiefly to the immense volume of British trade, the comparative stability of the British currency and to the fact that the seller of a bill on London can almost invariably count upon finding a buyer on advantageous terms.

For the recent change in the position of London as an international banking centre, refer to pages 158, 159, 160.

The Rate of Exchange.

We have seen that international payments are largely made through the cancellation of credits and debts and only a small amount of metallic money is needed for clearing the uncanceled balance remaining after the cancellation of credits and debts. *The large mass of international payments may be supposed to be represented by bills of exchange.*

The rate of exchange is the rate at which the money of one country can be converted into the money of another country and the process of converting the money of one country into the money of another country is carried out through the purchase and sale of foreign bills of exchange.

granted by London bankers, and also in the greater reputation of the London houses. The primary cause is to be found in the stupendous and never ceasing exports of England.' (Goschen—*Theory of the Foreign Exchanges*).

"A draft on London which is the real currency of international commerce and finance because money in the real sense of the word, gold or its equivalent, is only to be had, always and without question and to any amount in London . . . London's money is not only more genuine that is, more undoubtedly convertible than that of any other centre but is also under normal circumstances both more cheaply and easily produced to suit the convenience of the user." (Withers—*The Meaning of Money*).

Bills on London (but not on any other centre) are immediately and unquestionably convertible into gold. Again the vast exports of England create a vast demand for bills on London, and so these bills are always more saleable than other bills and on more advantageous terms. So business men of all countries prefer to get their payment by bills on London which have thus become the currency of international commerce—Chinese merchants exporting silk to America and American merchants exporting cotton to Russia, they all like to have their payments through bills on London which thus becomes the financial centre of the world.

In Adam Smith's time London did not possess this position of central importance in the world's trade and finance.

The rate of exchange depends chiefly upon the supply of and demand for foreign bills. What amount of money would an American importer pay in American money (dollars) to get from an American exporter a bill for £1000 on London depends upon the demand for and the supply of bills on London.

The subject of the Rate of Exchange is to be discussed under the three following heads:

(a) *The par of exchange between two countries and how it is determined* (b) *the limits to the fluctuations in the rate of exchange (viz., the gold points)* (c) *the fluctuations in the rate of exchange within those limits and the causes bringing about those fluctuations.*

(a) The Par of Exchange. Premium and Discount.

The word 'par' means a state of equality.

Let us consider the pre-war par rate between England and the United States, with both countries on the gold standard.

The rate of exchange between two countries is said to be at *mint par* when the rate is such that the money of one country can be converted into its exact metallic equivalent in the money of another country. [In the pre-war world with both England and the United States on the gold standard, an English pound sterling contains the same amount of pure gold as in 4.866 American dollars; and so when a £1000 bill on London sells in America for exactly 4866 dollars ($1000 \times 4.866 = 4866$) the exchange between England and America is said to be at mint par.]

When the total money value of exports from America to England equals the total money value of the imports into America from England, then the supply of bills on London will equal the demand for bills and exchange will be at *mint par*, other things being equal.

The rate of exchange is very rarely at mint par.

When a bill for £1000 on London sells in America for less than £1000 or less than 4866 dollars (i.e., when each pound of bill sells for less than 4.866 dollars in American money) then sterling exchange on London is said to be *below par* or at a *discount*.

When a bill for £1000 on London sells in America for more than £1000 (i.e., for more than 4866 dollars in America), sterling exchange (i.e., exchange calling for pounds sterling) on London is said to be above par or at a premium.

(b) Limits to fluctuations in the rates of exchange.
Specie points.

When the supply of bills exceeds the demand, the rate of exchange falls; and when the demand for bills exceeds the supply, the rate of exchange rises.

The rise and fall in the rate of exchange are ordinarily within very narrow limits fixed by the cost of transmitting bullion.

The object of using paper (bills of exchange etc.) is to save the cost of transporting coin from one country to another; and so variations in the rate of exchange (price of paper) cannot exceed the cost of transmitting coin because then it would be cheaper to transmit coin or metal than to use paper.

The two limits to fluctuation in the rate of exchange are thus:—

* Specie points or gold points. (a) Par value plus the cost of transmitting specie (maximum rate).

(b) Par value minus the cost of transmitting specie (minimum rate).

The specie points or gold points are these limits in the rate of exchange at which gold flows from country to country.

The rate of exchange does not rise ordinarily beyond the

* When the rate of exchange is at the upper gold point and is equal to the par value plus the cost of transmitting bullion, gold is exported and this point is called the upper specie or gold export point.

When the rate of exchange is at the lower limit and equals the par value minus the cost of transmitting bullion, gold is imported; and this point is called the lower specie point or the gold import point.

The cost of transmitting specie is a variable one, varying with the scale on which specie is transmitted and varying with changes in freight and insurance rates. And so the limits to the fluctuations in the rate of exchange, are not also absolutely rigid but are variable limits, changing with variations in the cost of carriage.

maximum rate given above because persons, who have to remit money abroad, will find it cheaper to send specie and incur the cost of sending specie rather than buy bills at a rate exceeding the par value of exchange by the cost of sending specie.

Similarly the rate of exchange does not ordinarily fall below the par value of exchange minus the cost of transmitting the specie. This is because exporters and other persons who have money owing to them from abroad will find it cheaper to call for specie from their debtors abroad rather than sell their bills at a rate which falls below the par of exchange by more than the cost of importing specie.

When do the Rates of Exchange pass beyond the specie points?

Ordinarily the rates of exchange fluctuate between the specie points. Under certain circumstances, however, the rates of exchange can rise above or can fall below the upper and the lower specie points determined by the cost of carrying bullion.

(a) The rate of exchange does not rise above the specie point so long as people find no difficulty in getting gold bullion for making payments to foreign countries. If there is a difficulty in getting gold bullion for export (because the banks are not willing to give gold or because the country has been drained of its gold by an adverse balance of trade or because the country has got a currency consisting largely of silver or paper etc.) then the rate of exchange will rise above the upper specie point.

(b) The rate of exchange does not fall below the specie point as long as bullion is freely imported into a country.

Bills in a country on foreign countries will fall below specie point when there is a sudden demand for cash in that country; when there is a monetary stringency, the holders of bills will sell these bills at a rate lower than the specie point to get the cash which they urgently want.

Goschen notes that in 1861 at the time of the American Civil War, exchange in America on England fell far below specie point. On account of the war the American holders of bills on London were in a panic, they would not wait and they had to sell their bills at a sacrifice and so exchange fell far below specie point.

(c) Fluctuations in the Rate of Exchange.

Within the limits of the specie points, the rate of exchange (the price of sight bills) varies as the demand for and the supply of bills.

When the supply of bills in a country on a foreign country exceeds the demand for such bills, the rate of exchange falls below par (it is said to be at a discount).

When America exports more commodities to England than she imports from England, in America the supply of bills on London being thus greater than the demand for such bills, the rate of sterling exchange (i.e., exchange calling for pounds sterling in London) will fall below par. Any other cause increasing the credits of America will tend to bring about a fall in exchange.

And when the demand for bills exceeds the supply, the rate of exchange rises above par, (it is said to be at a premium). When the total value of imports into America from England exceeds the total value of the American exports to England, then the demand for bills on England will exceed the supply of bills on England, and so the rate of exchange will rise above par.

(The rate of exchange is influenced by the interest rates in a country and abroad and by the many forces affecting interest rates)

Interest rates.

A rise in the rate of exchange will be moderated to some extent if the interest rate in America is higher than the interest rate in England. The higher interest rate in America will induce the English creditors to lend their money in America to earn the higher rate of interest, and so the demand in America for foreign exchange on London will be diminished, and thus the rate of exchange on London will be moderated.

Rate of exchange in relation to the total credits and debits of a country. Reparations and War Debts.

The rate of exchange depends upon a country's total credits (including exports of commodities) and total debits (including imports of commodities). When Germany pays an instalment of reparations, there is more demand in Germany for foreign money, and the value of German money tends to

fall as compared with foreign money. Similarly when England pays an instalment of war debt payment to the U. S. A.

In actual fact the rates of foreign exchanges are determined not simply by dealings between two countries but between a country and all the countries, with which it has dealings.

*** The interpretation of the foreign exchanges—favourable and unfavourable exchange**

The state of the foreign exchange depends (not upon exports and imports of commodities only but) on the total credits and debits of a country. Fluctuations in the rate of exchange are at once the necessary results and the certain index of the indebtedness of the different countries.

(a) *When the price of paper payable abroad is quoted above par in a country (i.e., when a given amount of money metal paid in the home country purchases the right of receiving a smaller amount of money metal in the foreign country), then the rate of exchange is said to be 'unfavourable' to the country.*

The rate is regarded by business men as unfavourable because such a rate leads to the exportation of bullion from

*** The rates of exchange form a valuable index of international indebtedness and properly interpreted give extremely useful indications of rates of interest, credit and currency conditions in different countries.**

Goschen in his masterly treatise refers to "the Foreign Exchanges in their peculiarly valuable character as an unerring mercantile and monetary barometer. The fluctuations in Foreign Exchanges, if properly interpreted, clearly indicate the state of the commercial atmosphere, and also suggest the course by which danger can be avoided and panic moderated. (*Theory of the Foreign Exchanges*).

"As an index of the general position of trade the value of short bills is the more important whereas the rates given for long paper . . . point mainly to the rate of interest and partially to the state of credit.

The two terms favourable exchange (with importation of gold) and unfavourable exchange (with exportation of gold) are now used accurately enough from the monetary or banking point of view—but not from the point of view of the country at large. An importation of bullion (favourable exchange) is favourable to business men and bankers for it tends to lower the rate of interest in the money market, and an exportation of bullion (unfavourable exchange) is unfavourable to business men and bankers for it tends to raise the rate of interest; the old mercantilist idea that an importation of bullion is favourable and an exportation of bullion is unfavourable to the country as a whole—this idea is now exploded and is no longer believed in by modern economic writers.

the country (and higher interest rates). When paper payable abroad (i.e., paper drawn on a foreign country) is quoted above par, it means that the demand for paper drawn on the foreign country is greater than the supply, and this happens when the country has imported more from the foreign country than it has exported and so the country is indebted to the foreign country; and the country will have to export bullion to pay for the excess imports.

[Such a rate is really unfavourable only to the importers in the country, because they have to purchase bills on the foreign country at the higher rate for making their payments; but it is favourable to the exporters, as they are able to sell their bills to the importers at a higher rate and thus the exporters make increased profits.]

(b) The rate of exchange is said to be favourable to a country when the price of paper payable abroad is quoted below par within the country (i.e., when a given amount of money metal offered in the home country will purchase the right to receive a larger amount of money metal in the foreign country).

Such a rate of exchange is regarded by business men as favourable because it leads to an importation of bullion. Such a rate results when the demand for paper drawn on the foreign country is less than the supply, i.e., when the country has imported less than it has exported and the country will import bullion in exchange for its excess exports.

[A 'favourable' rate of exchange is favourable only to the importers but it is unfavourable to the exporters.]

Economists have criticised the use of these expressions 'unfavourable' and 'favourable' exchange, on the ground that business men using these expressions seem to be under the influence of the mercantilist fallacy that an export of bullion is always injurious to a country and that an import of bullion is always beneficial to a country.

How the exchanges automatically tend to correct themselves.

A rise in the rate of exchange on account of a deficiency in the supply of bills, tends to correct itself by increasing the

profits of the exporters, stimulating exports and thus bringing about an increase in the supply of bills.

Similarly a fall in the rate of exchange on account of a diminished demand for bills, tends to correct itself by increasing the profits of the importers, stimulating imports, and thus bringing about an increased demand for bills.

•The correctives of the Exchanges.

An interpretation of the Foreign Exchanges naturally leads to the question of their correction when necessary and desirable. Automatic correction takes time, is not always possible, so other steps also become necessary. Again to quote Goschen "At all events it must be borne in mind that *which is really to be corrected is not the actual position of the exchanges but that state of things which has brought it about.*"

(i) *When the disturbance in exchange is due to depreciation of the currency*, the reform of the depreciated currency is the proper corrective.

(ii) When the unfavourable situation in exchange is caused by some disturbance in the balance of trade, or by rise or fall in the rate of interest—the correction lies in the regulation of the rate of discount in the money market.

In England this was done by the Bank of England manipulating its bank rate of discount. (See pages 232-233).

The Paper Exchanges.

How are we to determine the rate of exchange between a gold-standard country and a country with a highly depreciated paper currency? The answer is simple. Exchange payable in a depreciated paper currency must suffer a depreciation equal to that of the paper money itself.

And as the depreciation of paper may be considerable, the fluctuation in the rate of exchange as regards such a country may be very large and appear to have no limit at all.

The Silver Exchanges.

Metallic money also may be depreciated. During the latter part of the 19th century, the value of the silver money fell considerably in comparison with gold. The result was that claims by gold countries to be paid in silver by silver-using

countries got depreciated in value with the depreciation of silver.

The Indian Exchanges.

Since the closing of the Mints in India to the free coinage of silver, the rupee became a token coin with a coin value higher than its intrinsic value.

The coin value (or legal value) of a rupee was fixed at 1s. 4d. (i.e., $\frac{1}{15}$ of £1) and so the artificial par of exchange between England and India was fixed at Re. 1=1s. 4d. in 1899.

Ordinarily India exports more than she imports, there is an excess of exports even deducting what she must pay as Home Charges to England, and so the rate of exchange for bills on India is ordinarily above par. When exports fall off on account of a famine in India or other causes, then the rate of exchange falls and if the exports fall off greatly, it may fall below par.

The Secretary of State for India sells in England about £25,000,000 (or more) worth of bills on India annually to get payment for his Home Charges ; and by diminishing and when necessary by stopping the sale of his Council Bills he can do much to keep up the price of bills (or in other words the rate of exchange).

Since 1931 the legal value of the rupee is Re. 1=1s. 6d. *sterling*.

The War (1914-1918) and Foreign Exchanges.

The last World War has been specially rich and fruitful in matters relating to foreign exchange, and economic theory on this subject has stood the test remarkably well.

When war broke out, at once there was a crisis in foreign exchange, and foreign countries could not pay their debts to England. Gradually things settled down to some extent.

During the war, English exchanges with neutral countries were against England because England was receiving more goods from neutrals than England could export to them. English exchanges with allied countries were heavily in England's favour because the allied countries were receiving more commodities from England than they could send

to England. *All exchanges were against Germany, and to a much greater extent than against England.*

As regards India exchange on India fell heavily when war broke out, and subsequently exchange rose till towards the end of the war it stood at about 1s. 6d. for the rupee. The rate of exchange for bills on India (Council Bills and other bills) rises when there is a large demand for these bills to pay to India for heavy Indian exports; and the rate of exchange falls with decrease of Indian exports and increase of Indian imports. *Exchange on India fell at the outbreak of the war* because Indian exports diminished with the stoppage of exports to enemy countries (*viz.*, Germany, Austria, etc.) and the restriction of exports to some neutral countries; *and subsequently exchange rose high* because of (a) diminution in imports into India, and (b) increased value of exports (jute, tea etc.) for war purposes, and a large demand for bills on India (c) the restriction of the supply of Council Bills on India on account of a lack of currency. The imports into India fell off as England and other countries were largely taken up with the manufacture of munitions and war materials and so were sending much smaller amounts of goods to India during the war than before the war.

Exchange on India rose very high at a time (Re. 1=2s. 4d. in 1919) and this great increase in the rate of exchange was due in great part to the increase in the price of silver in the world's markets.

The rate of discount and the gold reserve.

The balance of indebtedness in foreign trade is continually fluctuating. At any moment a country may find that it has imported more than it has exported and that it will have to export bullion to pay for the excess imports if its creditors will not wait.

The bullion to be exported is gold bullion because gold is international money; and it will come from the bankers' gold reserves.

The bankers have to watch closely the movements of the rate of exchange to see when the rate of exchange becomes 'unfavourable' and exportation of gold necessary.

The bank or banks having charge of the gold reserve of the country, will naturally wish to lose as little gold as is possible under the circumstances.

Different courses of action are open to the banks for the protection of the gold reserve.

An important course is to raise the bank rate. Raising the bank rate has

(a) an immediate effect

(b) an ultimate effect.

(a) *Immediately it checks the drain by making the discount of bills costly*—maturing bills instead of being discounted and thus drawing gold out of the country are retained in the country on account of the increased cost of discounting. *And the raising of the bank rate attracts gold from foreign countries* because a country with a high bank rate is a profitable market for investment specially of short loans. •

(b) *Ultimately the high bank rate tends to remove the cause of the export of bullion.* The cause of the export of bullion is that the imports exceed the exports.

Now a high bank rate discourages borrowing on the part of merchants and manufacturers on account of the increased cost of borrowing, and so when the bank rate is high there is less money circulating within the country and, therefore, prices within the country fall. When the prices in a country are low, foreign countries will buy more in that country and will sell less to that country. In this way the fall in prices will increase its exports, and will diminish its imports,—and thus the excess of imports over exports, which was the cause of exportation of gold bullion, will disappear.

A rise in the rate brings about a depreciation of commercial paper and of stock exchange securities within a country, and leads to large purchases of this paper and these securities by foreign bankers and capitalists and this makes the country the creditor of foreign countries to the extent of these purchases; and this also helps to remove the indebtedness of the country which is the cause of the exportation of bullion.

Professor Cassel's Purchasing Power Parity Theory about Foreign Exchanges.

(The old classical theory about the rate of exchange) is that the balance of trade (or more comprehensively the balance of credits and debits) settles the rate of exchange. •

The new Purchasing Power Parity theory.

During and after the War immense quantities of paper money (mostly inconvertible paper money) were issued in the different countries of Europe. The result was inflation and increase in the level of prices in different European countries ;

and there were different degrees of inflation in the different European countries, the inflation being the worst in Russia and in Germany and there being a great deal of inflation in Italy, France, even in Britain. *Under these conditions of independent systems of inconvertible paper in different countries with inflated currencies and price levels, brought about by the War, how are the rates of exchange determined between currencies of different countries?* Professor Cassel, the great Swedish economist, asserts in his famous *Purchasing Power Parity theory* that under these conditions the rates of exchange are not determined by the balance of trade (as indicated in the old theory), the par rate of exchange between the currencies of two countries is determined by the relative price levels in the two countries. (The peculiarity of the *Purchasing Power Parity* is that it is a moving par, it varies with every change in the price levels in the two countries).

Suppose there are two countries each with a standard coin containing 50 grains of gold. The par of exchange between these two countries will be unity i.e., one unit of currency of the first country will be equal to one unit of currency of the second country. Then suppose that both countries introduce inconvertible paper currencies and paper standards, and suppose the first country has its currency doubled and the second country has its currency increased six-fold—then according to the quantity theory, other things being equal, the price level of commodities in the first country will be doubled and the price level of commodities in the second will be increased six-fold. And now the par rate of exchange between the currencies of the first country and the second country will be determined by their relative price levels according to the *Purchasing Power Parity theory* and one unit of currency of the first country will be now equal to three units of currency of the second country.

↑ This new *Purchasing Power Parity theory** (the theory is not new, in fact it is as old as Ricardo, though the name is a new one) is given below in Professor Cassel's own words :

"Our willingness to pay a certain price for a foreign money must

* Professor Cassel at first used the expression 'theoretical exchange

ultimately and essentially depend on the fact that this money has a purchasing power as against commodities and services in the foreign country. On the other hand, when we offer so much and so much of our own money, we offer, in fact, a purchasing power against commodities and services in our own country. *Our valuation of a foreign money will, therefore, essentially depend on the relative purchasing power of the currencies of both countries.*

..... When two currencies in two countries have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from these new normal rates, and, in a period of transition, these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the *new parity (or par of exchange)* between the currencies. This parity may be called the *purchasing power parity*, as it is determined by the quotient of the purchasing powers of the different currencies.

During the War the buying capacity of the different monetary standards (in the different countries of Europe) has, owing to the overabundant supply of means of payment, been much reduced, though in very different proportions. Consequently the purchasing power parities (as between the currencies of different countries) have undergone very important alterations and are now quite different from the parities which were in force before the War.

The purchasing power parities represent the true equilibrium of the exchanges and it is therefore of great practical value to know these parities."

The World's Monetary Problems—Gustav Cassel. Refer also to Gustav Cassel, *Money and Foreign Exchange after 1914*, pages 140-144, 147-162.

rate' and he used the expression 'purchasing power parity' for the first time in an article in the *Economic Journal*, December, 1918.

Professor Cassel's theory in its developed and considered form is to be found in his *Money and Foreign Exchange after 1914*.

The theory itself is essentially as old as Ricardo. The following extract is interesting. "If the trade in the precious metals were perfectly free—if they were generally used in circulation, even with the expenses of transporting them, the exchange could never in any of the countries deviate more from par than by these expenses *If a country used paper money not exchangeable for specie, and, therefore, not regulated by any fixed standard, the exchanges in that country might deviate from par in the same proportion as its money might be multiplied beyond that quantity which would have been allotted to it by general commerce, if the trade in money had been free, and the precious metals had been used, either for money or for the standard of money.*" (Ricardo—*Principles of Political Economy*, Ch. xvi.).

Some criticisms of the Purchasing Power Parity Theory.

(1) If the actual rates of exchange as between different countries from the end of the War up to some time after are examined, it is found that the results do not correspond to the Purchasing Power Parity theory. In actual fact the rates of exchanges between different countries do not correspond to their relative price levels.

Professor Cassel at first attempted to meet this objection by saying that these abnormal deviations of exchange from the Purchasing Power Parity were due to "one-sided restrictions on trade"; and later on he amplified his explanation of these abnormal deviations.

Mr. Gregory suggests that the actual divergences from the Purchasing Power Parity are largely due to the effects which the anticipated further inflation has exercised upon the exchange market.

(2) It is also stated that the purchasing power of a currency cannot be measured except by index numbers, and index numbers vary substantially and are only an approximation.

Mr. Keynes on the Theory of Purchasing Power Parity.

"The Quantity Theory deals with the purchasing power or commodity value of a given national currency. We come now to the relative value of two distinct national currencies,—that is to say, to the theory of the Foreign Exchanges.

When the currencies of the world were nearly all on a gold basis, their relative value (*i.e.*, the exchanges) depended on the actual amount of gold metal in a unit of each, with minor adjustments for the cost of transferring the metal from place to place.

When this common measure has ceased to be effective and we have a number of independent systems of inconvertible paper, what basic fact determines the rates at which units of the different currencies exchange for one another?

The explanation is to be found in the doctrine, as old in itself as Ricardo, with which Professor Cassel has lately familiarised the public under the name of Purchasing Power Parity

The ratio between the respective home purchasing powers of the two currencies is designated their purchasing power parity

The actual exchanges are often more sensitive and more volatile than the purchasing power parities, being subject to speculation, to sudden movements of funds, to seasonal influences, and to anticipations of impending changes in purchasing power parity (due to relative inflation or deflation); though also on other occasions they may lag behind. Nevertheless it is the Purchasing Power Parity, according to this doctrine, which corresponds to the old gold par. This is the point about which the exchanges fluctuate, and at which they must ultimately come to rest; with one material difference, namely that it is not itself a fixed point

In practical applications of the Purchasing Power Parity doctrine there are . . . difficulties The first difficulty is how to make allowance for transport charges and import and export taxes. The second difficulty is how to treat purchasing power over goods and services which do not enter into international trade at all. . . . But the essence of the Purchasing Power Parity theory, considered as an explanation of the exchanges, is to be found, I think, in its regarding internal purchasing power as being in the long run a more trustworthy indicator of a currency's value than the market rate of exchange thus, provided, no persisting change is taking place in the basic economic relation between the two countries, and provided the internal purchasing power of the currency has in each country settled down to equilibrium in relation to the currency policy of the authorities, then the rate of exchange between the currencies of the two countries must also settle down in the long run to correspond with their comparative internal purchasing powers. *Subject to these assumptions comparative internal purchasing power does take the place of the old gold parity as furnishing the point about which the short period movements of the exchanges fluctuate.*"—J. M. Keynes, *A Tract on Monetary Reform*, 1924, pages 87-97

How is the Value of Money determined internationally?
The natural connection between the Internal Value and the International Value of the Money of a country. The Rate of Exchange as between the Monies of two Gold Standard countries is a particular case of the General Theory about the determination of the International Value of the Money of a country.

The pound sterling is the monetary unit of England. The dollar is the monetary unit of the United States of America. In India the monetary unit is the rupee.

How is the value of the pound sterling determined in relation to the value of the dollar or in relation to the value of the rupee? What causes and conditions will make the value of the pound higher, will make it worth more dollars or more rupees than before? Again when will the value of the pound be lower and will be worth less dollars than before? In other words, how is the value of money in a country determined internationally in relation to the currencies of other countries?

The old classical theory about the determination of the value of the money of a country in terms of foreign currencies is based upon the balance of credits and debits. Refer to pages 224-228.

It has been already seen that *Cassel's Purchasing Power Parity Theory* was developed to supplement the old classical theory under conditions of mutually inconvertible paper currencies in different countries. When two countries have mutually inconvertible paper currencies, fluctuations in the rate of exchange between them cannot be adequately explained by the old classical theory.

Properly considered the determination of the international value of the money of a country is always connected in the following way with the determination of its internal value.

Suppose we are considering two countries A and B. The internal value of the money of country A will depend upon the conditions of demand (quantity of goods to be exchanged for money) in relation to the supply of money or purchasing power in the country and this internal value of money is indicated by the price level of commodities in the country and changes inversely with changes in the price level. So also in country B.

If the internal value of money in country A is indicated by its price level and the internal value of money in country B is indicated by the price level in country B, it is clear that the international value of the money of country A in terms of the money of country B will depend essentially on the relative purchasing power of the currencies of both countries as indicated by their respective price levels. *So the international value of the money of a country is thus related to its internal value in all cases—whether the two countries are both on the gold standard or both are on inconvertible paper standards with mutually inconvertible paper currencies.* But this is to be remembered that such large fluctuations are not found in the internal price level of a gold standard country as are found in the price level of a country on an inconvertible paper standard.

This general theory explains how the rate of exchange is determined between (a) two gold standard countries and (b) two countries both on inconvertible paper standard. The fact that the rate of exchange between two gold standard countries fluctuates within narrow limits and remains within the gold points is a result of (1) gold being the most mobile of commodities in the international trade between nations, and (2) fluctua-

tions in the internal price level being usually much less in gold standard countries than in countries under inconvertible paper standards.

The Forward Market in Exchange.

Spot exchange transactions are to be distinguished from forward contracts in exchange.

In a 'spot' exchange transaction as between two countries (say Britain and India), cash in the currency of one country is exchanged for cash in the currency of the other country. "A forward contract in exchange is for the conclusion of a spot transaction in exchange at a later date fixed on the basis of the spot rate prevailing at the original date." A merchant in India who has purchased goods in Britain in terms of British currency may not have the cash or may not like to part with it before the goods are delivered. Such a merchant may enter into a forward contract in exchange fixed on the basis of the spot rate prevailing at present; he will have to pay cash not now but at the future date when the forward contract will mature and yet by this forward contract he is protected from the consequences of exchange fluctuations in the intervening period.

Differences between Spot and Forward Rates of Exchange.

(1) The difference between the forward rate of exchange at a given point of time and the spot rate of exchange is due partly to the risk of exchange fluctuations in the intervening period.

And in extreme cases when the risk of exchange fluctuation is very great because of apprehended political disturbance or financial trouble or a moratorium etc., bankers may be unwilling to enter into forward contracts at all.

(2) The difference between the spot rate and forward rate of exchange as between settled countries like Britain and the United States is due largely to the rate of interest for short loans prevailing in the two countries.

The forward rate of exchange also may be greatly influenced by the activities of speculators who have often proved correct in their forecast of exchange fluctuations.

International banking centres—London, Paris, New York.
Refer to pages 158-160.

A Good System of Money should secure Stability of Prices and Stability of International Exchanges.

There are advocates of falling prices (with increasing productive power) and also of gently rising prices. But most

economists of the present day favour broadly *stability of prices* (stability of the internal price level) of commodities within a country as best conducive to the economic interests of a country and securing a fair measure of justice to the different classes within that country, namely, the employers, the labourers, persons with fixed incomes, investors and creditors, debtors, taxpayers and consumers generally. Among the leading advocates of stabilization of prices may be mentioned Irving Fisher, the great American authority on Money, Gustav Cassel, the great Swedish economist, and J. M. Keynes and R. G. Hawtrey, the brilliant English stabilization champions.

Stabilization of international exchanges (i.e., the rates of exchange as between the currencies of different countries) is also greatly to be desired. Without such stabilization the foreign trade of a country is apt to be disorganised inflicting great losses on different classes of the population.

If it is possible for a country by suitable currency and other arrangements to secure both (1) stability of the internal price level and (2) stability of international exchanges with other countries, that would indeed be a highly desirable state of things. Suppose a country is not in a position to secure both (a) internal stability in the value of money and (b) external stability. Suppose one has to be sacrificed. Which is the less important and therefore to be sacrificed?

Most people will agree—and Mr. Keynes is among them—that though a hard and fast rule applicable to all countries may be out of the question, yet generally if we have to choose between the two, stability of the internal price-level is to be preferred to stability of international exchanges.

Very generally, the internal trade of a country is of larger volume and importance than its external trade; and so to maintain internal stability in the value of money is of greater importance to a country than to maintain external stability.

For Britain and other countries which are again on the paper standard since September 1931 and after, the chief aim should be to maintain internal stability as much as possible, the maintaining of the stability of the home paper money in terms.

of the money of foreign gold standard countries being not possible to any full extent.

I. Britain.

In 1925 Britain re-established the gold standard.

The question of the restoration of the gold standard in Britain led to a great controversy between the champions of the gold standard and its opponents.

The two schools of opinion on this question are sometimes called (1) the Cambridge School, and (2) the London School.

(A) The Cambridge School arguments against the restoration of the Gold Standard.

The Cambridge school economists opposed the gold standard and a chief of them is Mr. J. M. Keynes whose views on the subject are ably and lucidly set forth in *'A Tract on Monetary Reform.'*

Some of the arguments of Mr. Keynes against the gold standard are given below :—

(1) *"The gold standard is already a barbarous relic."*

Though gold maintained its stability of value with considerable success in the 19th century, it is not likely to do so in future. New deposits of gold may not be found in the near future and new improvements in methods of production may not come in the near future and then gold will become too dear. Professor Cassel fears a serious shortage of gold from his examination of the statistics of gold production in recent years. Or gold may become too cheap by some new chemical invention. And at present the value of gold depends too much upon a single country, the United States and the policy of its Federal Reserve Board because the United States have accumulated an immense gold reserve during and after the War.

The present and the anticipated instability in the value of gold make undesirable the restoration of the gold standard in Britain—“the value of a yellow metal, originally chosen as money because it tickled the fancy of savages, is clearly a chancy and irrelevant thing on which to base the value of our money and the stability of our industrial system.”*

(2) The restoration of the gold standard can be brought about in Britain only by an active policy of deflation and such deflation which causes falling prices means impoverishment to labour and enterprise by leading entrepreneurs to restrict production in their endeavour to avoid loss to themselves; and is therefore disastrous to employment. *Industry will thus be greatly hampered and unemployment seriously increased by the restoration of the gold standard through deflation.*

* Robertson—*Money*.

And Mr. Keynes asserts with truth that the restoration of the gold standard in Britain has brought about a check to production and to the export trade and increasing unemployment within the country.

(3) For England stability of the internal price level should be the primary objective and exchange stability, a secondary objective, is to be secured by co-operation with the Federal Reserve Board of the United States in a common policy. Stability of the internal price level (stability of sterling prices) and stability of trade and employment are to be secured by suitable contraction and expansion of credit needed to preserve stability—and for this Mr. Keynes depends upon joint control to be exercised by the Treasury and the Bank of England.

Stabilization thus secured will have greater beneficial effect upon industry, trade and employment than any advantages associated with the restoration of the gold standard.

As pointed out elsewhere Mr. Keynes will separate entirely the gold reserve from the note issue—he will not use gold reserves for maintaining the convertibility of notes within Britain, he will use gold reserves for securing exchange stability with the United States when it is affected by temporary or occasional causes.

(B) The London School arguments for the restoration of the Gold Standard.

Most of the British bankers belong to this school. Their opinion was that the recommendation of the Cunliffe Committee of 1918 about the restoration of the gold standard in Britain should be translated into practice. The British Government accepted this opinion and re-established the gold standard in Britain in 1925.

The views of the London school have been set forth with characteristic wit and vigour by Mr. Hartley Withers in his widely circulated book *Bankers and Credit*.

Some important arguments for the restoration of the gold standard in Britain were the following :—

(1) The gold standard before the War maintained prices in Britain roughly on a level with those in other countries and so secured stability both (i) in internal prices and (ii) in rates of exchange; and with proper safe-guards the gold standard will do both these things in future. Surely this is better than Mr. Keynes's scheme of (possibly) stabilized prices, with unlimited fluctuations in exchange.

(2) The gold standard is necessary for restoring the prestige of British national credit and the supremacy of London in international finance.* The use of the sterling bill as an international exchange

* "London's financial leadership is a source of direct profit to a few, and also indirect benefit to many, because London's right to demand payment from foreigners for its services strengthens the lien which this country holds on the food products and raw materials of the world (Robertson—*Money*, Chapters VII).

medium depends essentially on its convertibility into gold and so it will retain its wide acceptability only under a gold standard.

(3) The gold standard is more suitable for ensuring stability of prices and trade than the theoretical schemes propounded by Mr. Keynes and others. In a country like England so subject to foreign influences on her trade outlook, depression might easily arise that could not be cured by domestic monetary devices"* like those proposed by Mr. Keynes. "And even when credit is expanded prices do not always rise as was seen in the years 1890 to 1895."

(4) The gold standard is substantially automatic and is thus superior to Mr. Keynes's scheme of a managed currency jointly controlled by the Bank of England and the Government.

† "The intervention of the Treasury involved by Mr. Keynes's proposal, opens a door to interference by the House of Commons in a sphere in which its activities are far from desirable.

The gold standard frees us from muddling with our money by politicians, has worked right well in the past and may do so again."

Deflation and Devaluation.

Deflation.

Deflation has been already explained—see page 44. Suppose the paper pound in Britain becomes really worth half of the former metallic pound sterling though nominally it is worth a pound. Now if the quantity of currency in the country is reduced to half, according to the quantity theory, the value of the money (paper pound) will increase and it will be doubled and will be thus equal to the former metallic pound sterling. Here we have an example of deflation.

Devaluation.

(Devaluation consists not in reducing the quantity of money and thus increasing its value but in retaining the same quantity of money but giving each unit a lower value determined by the circumstances of the case.) For example in this case, the paper pound, though nominally worth a pound yet because of inflation really worth half of the former metallic pound sterling,

* Hartley Withers—*Bankers and Credit*.

† Hartley Withers—*Bankers and Credit*.

is to be made by devaluation worth half a pound which is its real value.

The effects of devaluation and deflation are practically the same. (See the effects of deflation).

Devaluation is not so easily intelligible to the general body of people as deflation and this many would regard as an additional objection.

India and the Gold Standard.

When the Royal Commission on Indian Currency and Finance reported in 1926, the great majority of Indian writers favoured the introduction of a gold standard with a gold currency for India, and their opinion was that *a gold standard would have secured both (1) internal stability of prices and (2) stability of international exchanges.*

Gold Production.

There has been a great increase in the production of gold in recent times—more gold was produced between 1850 and 1875 than from 1492 to 1850.

"The total production of gold was greater during the twenty years 1891—1910, than it was during the forty years 1850—90; and during each of these periods it was much greater than it had been during the centuries that elapsed between 1493—1850. This vast addition to the stock of gold was the foundation of the rise in prices which took place in the Western nations, and indeed the world over, during the first decade of the century (1900—10)." (Taussig—*Principles*, Vol. I).

The causes of this huge increase in the production of gold are (1) the opening up of new mines in Australia, in South Africa, in Canada, the United States and Alaska and (2) the great improvements in mining methods.

The effects of this enormous increase in the production of gold were widely felt in pre-War Europe, in pre-War America and even in distant India linked to gold standard countries by her gold exchange standard.

(a) Prices rose on account of the increased supply of money and the question of high prices seriously engaged the attention of economists and politicians all over the world.

(b) Wages also rose but not in proportion to the rise in prices ; and so the wage-earners suffered severely.

How a rise in prices due to increase in the supply of money affects different classes of people has been described on pages 47, 48 etc.

As regards the future, different opinions are expressed. Prof. Cassel, a great authority, and many with him fear a world shortage of gold at no distant date if gold is not properly economised by international co-operation.

The future of Gold—danger of future instability in the value of Gold. Gold is not now a stable standard of value.

It is not quite impossible that chance discovery of highly productive mines in some parts of the world and great improvements in mining methods in future may bring about a great increase in supply and a great fall in the value of gold. A considerable rise or fall in the value of gold in future due to shortage or excess supply of gold will seriously disturb stability of the value of money—will seriously disturb gold-based currencies and economic conditions in all civilised countries.

Cassel and other economists point out that the world economic depression and lack of international co-operation as regards gold have brought about large fall in the prices of commodities in general and a large rise in the value of gold. *Gold has now thus lost much of its stability of value as money* and this has reduced its usefulness as a standard of value.

If the nations of the world get economically civilised enough quickly, then the restoration of the international gold standard may not become necessary. With scientifically managed paper standard, the nations may be able to maintain internal as well as external stability in the value of money.

If the nations of the world do not get economically civilised enough so quickly, the international gold standard will have to be restored. It will be able to maintain internal and external

stability in the value of money, only by a policy of largely economising gold and by international co-operation among central banks and governments for securing that every nation gets its due share of gold. Signs of such international co-operation on a sufficient scale are not yet forthcoming.

MONETARY REFORM PROPOSALS.

There have been proposals for monetary reform for securing stability in the value of money—the fundamental requisite in every good currency system. *Many were made before the days of the World Economic Depression.* They were not simple, easily intelligible to the people, so not popular—they “pleased not the million ; caviare to the general”.*

(1) The Tabular Standard of Value (Multiple Standard or the Index-number Standard). A standard for deferred payments.

In the modern business world, the great majority of business transactions are done on credit; the payments are deferred, they are made 30, 60, or 90 or more days after the purchase of goods. Now steadiness in a standard for these deferred payments has been strongly advocated on the ground that such steadiness will prevent creditor as well as debtor from making undeserved gains and losses through changes in the value of money.

Various sorts of standards of deferred payments have been proposed to realize this object; and one of the more important of these is the *tabular or multiple commodity standard* which has received a great deal of attention from politicians and economists.

The Tabular Standard is based upon the Index Numbers of prices of commodities. (As it is based on the prices of many commodities it is also called the *Multiple Standard*).

Under a Tabular Standard deferred payments would be regulated by an officially kept system of index numbers—the *principal of the debt would be increased with an increase of prices as shown by index numbers and it would be decreased with a decrease in prices.*

If a man borrows £1000 in the year when the index number of prices is 100 and if he has to repay it after a year when the index number

* Shakespeare, *Hamlet*, II. ii.

has risen to 120 he will have to pay £1200, to compensate the creditor for the fall in the value of money. £1200 will now buy as much commodities—and will be worth the same as £1000 when the index number was lower, viz. 100.

The argument in favour of the Tabular Standard.

Advocates of the Tabular Standard declare that it maintains justice between creditor and debtor by providing for the repayment of the same amount of goods and not the same amount of money (the value of which may have changed).

Neither the creditor nor the debtor is allowed to gain or lose through fluctuations in the value of money. The principal sum of the debt is increased or decreased according to decrease or increase in the value of money as indicated by index numbers. In this way the value of the debt in terms of commodities remains unaltered, the creditor always gets from the debtor the same value in terms of commodities which he lent to him.

Objections against the Tabular Standard.

(1) An important objection urged by Prof. Kinley is this. The tabular standard is not so just as it appears at first sight. Under it the same amount of goods is returned to the creditor whatever may have been the changes in prices; and so the *benefit of a rise in price goes entirely to the creditors and the benefit of a fall in price goes entirely to the debtors*. The really just thing would be, however, to divide the benefit from rise or fall between creditors and debtors.

(2) With gold as a standard of value and all other forms of money convertible into gold, changes in prices are not likely to be rapid enough to do much injustice to either creditors or debtors,—so the *Tabular Standard becomes unnecessary*.

(3) The Tabular Standard is also not suitable for business debts for periods in which price fluctuations are not large enough to require any correction.

The Tabular Standard also produces difficulties in the cancellation of bills of exchange, because bills will have fluctuating values under the varying Tabular Standard.

Prof. Taussig maintains "The conclusive objection is that under the multiple standard certainty and calculability would cease to exist in all transactions involving postponed payments. No man would know when contracting a debt, what he would be called on to repay when it became due. He would have to watch each monthly or quarterly report of the index-number and guess in the meanwhile how his affairs would have to be adjusted."—*Principles*, Vol. I, Chap. 31).

(II) Irving Fisher's compensated dollar.

Prof. Irving Fisher has given a clear statement of his scheme in his book *Stabilising the Dollar* (1920). Like the multiple standard, Fisher's scheme also is based upon prices and index numbers. *Under the multiple standard* a person borrowing 100 dollars in America when index number is 100, will have to *repay 120 dollars* if at the time of the repayment index number is 120—in this way he will be repaying to his creditor the same purchasing power in terms of commodities. *In Fisher's scheme* he would be repaying 100 dollars—not 120 dollars as under the multiple standard—but each dollar with a proportionately larger gold content. In case of a fall of index number, the debtor would be repaying the same number of dollars that he borrowed, but each dollar would have a proportionately lower gold content. Prof. Fisher would adopt a currency in which gold coins or notes, whichever were used were redeemable in bullion, not by a fixed weight of metal, but by a weight adjusted to represent a fixed value of goods. In other words *the dollar would be purchasing always the same amount of goods*—it would be a *stabilised dollar*. *And stability in the value of money* (i.e., in the value of the dollar, not in the value of gold) *in terms of commodities would be secured*.

Probably gold coins would not be used within the country; paper money would be used within the country and gold would be reserved for export. The currency authority (government treasury or central bank) issuing the money would be bound to exchange notes into bullion and bullion into notes—reducing or increasing the quantity of gold bullion paid for the paper money (say the dollar note) as prices fall or rise indicated by the index number.

A most serious disadvantage of the multiple standard is its paralysing uncertainty—the debtor borrowing 100 dollars does not know how many dollars he will have to repay, it will all depend upon changes in the index number. Fisher's scheme is without this difficulty, and hence it is likely to be somewhat more popular and capable of being more easily introduced. In Fisher's scheme the debtor repays the same number of dollars that he borrows—though the dollar would be exchangeable into a smaller or larger quantity of gold bullion depending upon index number variations.

(III) The Keynes Ideal of a managed paper currency and the abandonment of the gold standard.

* Mr. J. M. Keynes's plan for monetary reform with a view to securing stability in the value of money is of a revolutionary character. To quote his own words "*Therefore I make the proposal—which may seem, but should not be shocking—of separating entirely the gold reserve from the note issue.*"

The volume of paper money is to be used as an instrument for securing stability of trade, prices and employment; and for this purpose the volume of paper money is to be regulated by a suitable bank rate policy and treasury bill policy and it is not to depend upon the gold reserve The only employment for gold is as a store of value to be held as a war-chest against emergencies and as a means of rapidly correcting the influence of a temporarily adverse balance of international payment." Inconvertible paper money is to be injected into the circulation or withdrawn from it (as prices fall or rise indicated by index numbers) thus securing stability in the value of money. As regards Mr. Keynes's interesting and ingenious scheme of 'a managed paper currency' and his proposals to regulate prices by means of credit and currency management, Mr. Hartley Withers puts forward among other things the following objections:

(i) The intervention of the treasury involved in Mr. Keynes's proposals, opens a door to undesirable interference by the House of Commons in credit and currency matters.

(ii) In a country like England subject to foreign influences in her trade outlook, depression might easily arise that could not be cured by domestic monetary devices (like the regulation of the volume of credit and currency by suitable bank rate and treasury bill policy).

It is generally maintained against Mr. Keynes's scheme* that the governments of even the advanced countries are not yet wise and honest enough to be entrusted with such a responsibility.

† The gold standard is the practicable ideal. National and international currency arrangements.

This was the opinion of most economists before the World Economic Depression.

The proposals of the currency reformers are not without their theoretical and practical difficulties; and they would have to wait so long businessmen and governments are not better educated in currency matters. For the present the gold standard* is the only practicable ideal for securing a reasonable measure of stability in the value of money.

* Much the same line of criticism is pursued by Prof. Taussig against Fisher's scheme and also the scheme of a managed paper currency. "It rests also on a fictitiously simplified form of the quantity theory. It would operate irregularly, unpredictably, with surprises and disappointments, almost certainly with incidental consequences not foreseen at the start. It would be exposed to all the froth and foam of popular clamor. But if carried out with unflinching persistence, it would achieve in the end, not indeed a smooth and even range of prices, but a greater approximation to long-period stability than the unadjusted specie standard."

† The gold standard "has the essential advantage that the available quantity rests in the end on the limitations of physical nature and is

The future is always an interesting subject of speculation. Prophecies are dangerous—nowhere more so than in currency matters. In times to come nations may become economically civilised enough to manage with paper money and to do away with the Gold Standard. The gain to a nation from substituting paper money in place of gold will be multiplied many times if, a scheme of international paper can be realised to replace the present expensive currencies of nations based on the precious metals. Labour and capital now engaged in producing gold and silver for money purposes would be saved; and a scientific regulation of the quantity of money and its value would be possible with international paper

therefore not subject to the caprice of man. It is rooted in the traditions and habits of the entire world, both that which we call civilised and that admittedly uncivilised. Much allowance must be made for this historical and psychological factor. In a world which cannot break suddenly with the past, devices quite out of accord with established ways are impracticable. The best check to irregular fluctuations in the volume of "money" and also to irregular fluctuations in the use of the credit substitutes for money, is that all shall rest securely on gold the world over. . . . *It is not a perfect arrangement; but it is the best workable one that is available*" (Taussig—*Principles*, Vol. I). "The gold standard with its present and prospective instability has been rightly described as an expedient fit only for a barbarous age. But can any one who has lived through the Great War have any doubt that a barbarous age is precisely what we have for the moment to provide for? The cruder and simpler principle (i.e., the gold standard) may suit us best for the present and immediate future" (Prof. Cannan in *Economic Journal*, June 1924).

"The line of progress is to perfect the existing national currencies : to bring them into more stable relations with each other and gradually to facilitate the adoption of a common unit and free transfer . . .

The immediate future of monetary organisation was the subject of discussion at the Genoa International Conference of 1922, and the resolutions adopted there give a good indication of what is practicable. The Conference looked forward to the re-establishment of the gold standard, either by devaluation or by deflation, in those countries which had departed from it. This was regarded as a first step needed to emerge from the chaotic state left by the war, it being the only common standard that European countries could at present agree to accept. Next, co-operation between central banks was to be instituted; to facilitate foreign payments the banks were to keep reserves in the form of balances in and bills on foreign countries (in practice that would mean in London and New York, these cities acting as clearing houses, London being the more suitable for European trade). Participants were to maintain convertibility and a free market in gold, and as a sanction to ensure this, a defaulting state was to be debarred from the right to hold reserve balances with the central banks of the other participating countries. Further, the central banks were to adopt a policy tending to avoid undue fluctuations in the purchasing power of gold" (Lehfeldt—*Money*).

The war revived schemes of international paper money. Schemes of international paper are now but dreams and nothing more; they would require a higher degree of civilisation and more cordial co-operation between nations than is possible at the present stage.

PROTECTION. FREE TRADE.

Protection.

Restrictions on international trade have been imposed by nations from very early times at different times and places. These have been imposed with different objects in view.

In modern times many nations regulate international commerce with the object of weakening foreign competition with domestic industries by such regulations and protecting and developing in that way domestic industries. Such a policy is called the *policy of protection* and the theory underlying it is known as the *doctrine of protection*. Generally protection seeks to encourage domestic industries against foreign competition by taxing imported foreign commodities which compete with domestic industries. These taxes are called *protective duties* (or *taxes*) and collectively they form a '*protective tariff*.' (Protectionists sometimes protect domestic industries not only by taxing competing foreign commodities but also in some cases by granting *bounties* to domestic producers).

To-day all nations of the world follow the policy of protection. Now the whole world is protectionist.

But the policy of free trade in certain circumstances has strong supporters among economists.

Free Trade.

As opposed to the policy of protection we have the policy of free trade. *A nation is said to have free trade when it does not impose any restrictions upon its international trade with the object of protecting its industries from foreign competition. A free trade country may impose taxes upon foreign imports for the purpose of getting a revenue, but such taxes are not intended to protect domestic industries. (Taxes imposed upon*

foreign commodities for revenue purposes are collectively said to form a 'revenue tariff' as opposed to a 'protective tariff').

Free trade in modern times means the freedom of international trade from government interference and restrictions.

* Arguments for Protection.

I. Some arguments in favour of protection :

* "*Protection to a nascent industry in a country where capitalistic resources are scarce, is not necessarily unreasonable. But in fact the greater part of such protection is commonly retained after the industry has already enjoyed a long and prosperous life.*

Taxes on imported manufactures are convenient sources of revenue in such a country as Brazil, whose conditions make the collection of revenue over the large inland area difficult, while it can be easily collected at her ports. *And a protective tax which helps a young industry to develop its latent strength, may be in the interest of an undeveloped country even though the tax must inevitably do some hurt to those few of her industries which are manufacturing for exportation. For the energy developed in a few high class progressive industries may spread over a great part of the industrial system of the country.*

But neither of these arguments applies to an old manufacturing country. Occasionally it may be concluded that, *when no other means are available for bringing national resources to the aid of a particular backward industry, a state may act wisely and rightly in subsidising it at the expense of the population at large.* (From the United States) I came back convinced that a *protective policy in fact was a very different thing from a protective policy as painted by sanguine economists* such as Carey and some of his followers, who assumed that all other people would be as upright as they knew themselves to be, and as clear-sighted as they believed themselves to be. I found that, however simple the plan on which a protective policy is started, it was drawn on irresistibly to become intricate; and *to lend its chief aid to those industries which are already strong enough to do without it. In becoming intricate it became corrupt and tended to corrupt general politics.* On the whole, I thought that this moral harm far outweighed any small net benefit which it might be capable of conferring on American industry, in the stage in which it was then.

Subsequent observation of the course of politics in America and elsewhere has strengthened this conviction" (Marshall—*Money, Credit and Commerce*).

The case for Free Trade. Valid arguments for Protection.

"The development of international trade under conditions of freedom is in itself the proof of gain by national specialisation; if there were no gain, there would be no trade. "If goods which can be produced at home, are yet imported freely from abroad, that shows

(I) Economic arguments.**(1) The argument that international trade is international economic warfare.**

Some protectionists declare that *'international trade is economic warfare between nations*; and that free trade between nations which are

that they can be got generally at less cost by making other things with which to buy them from abroad than by the direct method of making them at home."

"Concentration in work is the key to variety and abundance in consumption." The moral of this, as applied not to individuals but to countries, is that even if one country be superior to another country at every kind of production, trade between them may still develop and be profitable to both. The maximum output of the two together will be obtained by the superior country concentrating on those branches of work for which it has greatest advantage, and leaving to others those where its advantage, though still existing, is relatively less. This principle, known to economists as *the theory of comparative costs*, has important practical bearings on the problem of trade between countries of widely different standards of living and wage rates. This is the principle which makes it advantageous often for one country to buy from another articles which it could itself make more cheaply. It will come up again and again in the discussions that follow.".....*What reasons can be given for restricting the freedom of citizens to trade abroad as freely as at home? They are broadly two.*

The first doubt arises from the possibility of conflict between the economic interests of the nation as a whole and of some of its individual members. The Free Trade case is that, if the individual citizens of a country are left to seek their own interest in deciding what to produce and how and where to buy and sell, the country will in general have those occupations and industries for which the people and resources are best suited, and which will therefore yield the largest measure of prosperity. Against this it is pointed out that individual self-seeking may not always lead to general good. Individuals naturally take narrower or shorter views than the State. Perhaps it would be safer to say that the State, if it knows its business, should take broader and longer views than individuals; should sometimes step in to prevent extreme individualism from sacrificing the greater good to the less, the permanent to the passing good. This is the argument that has to be advanced, not for tariffs only, but for every kind of interference by the State in economic affairs; for the factory laws and minimum wage Acts and all their like. Its application in the field of international trade is to serve as the philosophical basis underlying most arguments for protection of infant industries, for defence against dumping, and for customs unions or preferential trade within tariff walls.

A second consideration commonly influencing judgments on inter-

industrially strong and nations which are economically undeveloped will lead to the enrichment of the stronger nations and to the destruction of the weak,—so protection is necessary in the interest of the weaker nations.

[This argument is not a valid one because no nation is inferior to other nations in all branches of production.]

A few popular arguments in favour of protection are the following:—

(2) The balance of trade argument.

This is an old protectionist argument. It is used by the old mercantile writers of Europe. It maintains that a nation should, by a policy of protection, reduce imports, should thus secure an excess of exports over imports—and should thus bring about an importation of metallic money, this being the true object of international trade. It is clear that this argument contains very serious fallacies. (a) The true object of a country—its real gain—in international trade does not lie in the importation of precious metals. This lies in importing commodities more cheaply than they could be made within the country, and devoting its own labour and capital to industries for which it is best fitted by its resources of labour, capital and Nature's aids. The real wealth of a country is to be found not in abundance of money but in abundance of commodities. (b) Also gold is imported when credits exceed liabilities—not when exports exceed imports. (c) And in the long run, total credits equal total debits.

(3) The Home-market Argument.

Foreign markets are (1) distant—there is the cost of transport; and (2) precarious, too, they may be cut off by wars or by changes in the tariff policy of foreign governments. Home market is steadier, more secure and near at hand. It is therefore desirable that the steady home market should be secured to domestic producers by a policy of protection.

national trade is the conception of the State as existing for other than strictly economic purposes; for defence, or for a particular type of life or culture. This consideration, again, is not peculiar to problems of international trade, and boundaries between economic and other purposes are hard to define. But it is convenient to distinguish between arguments turning upon more or less of wealth measured in terms of money, and arguments directed to such ends as securing a fair proportion between urban and rural life in each country, or being prepared for war, or linking trade with particular political ideas and institutions such as those of the British Empire.”—*Tariffs, the Case examined by a Committee of Economists*, Chap. II.

Protection benefits industry—and also agriculture. The development of industries and industrial towns within a country under protection with increasing population and wealth will afford a larger market for the food and raw material produced by the agriculture of the locality.

Some protectionists maintain that free trade makes the distribution of labour and capital within a country subject to the control of the foreign country to which it exports its goods. The foreign country will, by protection and other means, develop within its territories those industries which are conducive to the physical, mental and moral welfare of the nation, leaving to the other country the less desirable industries.

The home-market argument is one of the earliest protectionist arguments in the United States. It was much used by the manufacturers and by farmers. But now the American farmers and producers in mines and many manufactures produce more than is required by the home market. Hence the foreign market has become of great and increasing importance. The cost of transportation to the foreign market has decreased much due to development of transport facilities—railways, shipping etc.

(4) The employment argument or make-work argument.

Protection creates new domestic industries in a country by shutting out foreign competition and thus provides more employment for labour and capital.

[This argument is not a strong one. When there are less imports on account of protection, there will be also less exports. The exporting industries will thus suffer and there will be less employment in them.]

(5) The wages argument in the United States.

The protectionist argument, most popular among the labouring classes in the United States for the last half century, is that *protection raises wages* or keeps them high. High protective duties on foreign goods shut out the cheap foreign commodities made by cheap foreign labour, and make possible high prices for domestic goods and thus enable business men to pay high wages to labour.

[This argument is also not a valid one. Wages were high under Free Trade in England. They are low under Protection

in Russia. Of course wages are high under Protection in the United States. But wages in the United States are high even in those industries which are not protected ; the high wages are due mainly to the high productivity of labour and abundant natural resources.

Of course in some of the protected industries, wages are kept up artificially by protection ; but free traders maintain that under free trade, labourers, engaged in these industries, will be able to find as well paid employment in other industries more suited to the country.]

(6) The equalization of cost argument.

This was the latest form of the protectionist argument in America before the present war.

The protectionists declare that the American labourer receives higher wages, and so the cost of production for commodities in America is higher than in Europe ; and to protect American labour and industry, taxes should be levied on foreign commodities so as to equalise domestic and foreign costs.

Of course this argument has some good points.

But how to calculate costs ? Again costs may be different in different foreign countries. Again if cost "plus a reasonable profit" for the business men is asked for—that may mean a high (and) injurious form of protection.]

The arguments in favour of protection, which we have already discussed, do not make out a good case for protection and do not justify its introduction. There are other arguments in favour of protection some of which possess considerable elements of strength.

(7) The argument from vested interests.

[Protection is also advocated for industries which are no longer infants on the ground that foreign competition will ruin these industries. This is an argument for the protection of the vested interests of capital and labour. Fixed capital is immobile and also to some

extent many kinds of labour; and the loss due to protection is to be borne to avoid a great loss to the capital and labour engaged in these industries.

[The argument applies only to exceptional cases and under exceptional circumstances; and it should not be used as a general protectionist argument by any progressive community.]

This may be a consideration not for suddenly abandoning protection, but it is no argument for the introduction of protection.

(8) The dumping argument.

Dumped goods disturb the industries of the country into which they are dumped and such a country would under certain circumstances be justified in preventing its industries from being disturbed by the unfair competition of dumped goods.

(9) Protectionists have held that *customs duties on foreign goods are the best kind of taxes* as they are paid by foreigners and these duties at the same time protect domestic industries from foreign competition.

[Customs duties which are high enough to shut off foreign competition will protect domestic industries but there will be no revenue for the Government as foreign commodities will not be coming in. So we see that *effective protection for domestic industries and large revenue for the Government do not go together.*

Also it must be remembered that *customs duties are not always paid by the foreigners*, they are very generally shifted by the foreigners wholly or partly to the shoulders of the domestic consumers.]

(10) Protection as a temporary economic policy—The infant industry argument for India and other backward countries.

The strongest economic argument in favour of protection is the infant industry argument.

Infant industries (including 'unborn infants') should be protected during their infancy from foreign competition and thus helped to grow up to maturity.

A country which wants to start a new industry has to meet certain *initial difficulties* regarding labour, capital and organization ; it has to train the labour force in that industry and it will have to attract capital and organization to the new industry started and in overcoming these initial difficulties the country will be helped by a policy of *temporary protection for the infant industry*. When these infant industries have grown up and are in a position to compete successfully with foreign industries as regards the prices and qualities of goods, then only protection should be withdrawn and free trade should be established. *Protection is used as a temporary expedient and the ultimate goal is free trade.*

The temporary loss to the consumers from protection is compensated by the ultimate gain to the country in the shape of the establishment of new industries, (and according to List, increase of productive power).

When the infant industry has grown to maturity then competition between domestic producers will lower the prices for consumers.

The *theoretical validity* of this argument has been admitted by almost all economists. Its truth was recognised by J. S. Mill, one of the staunchest and sanest advocates of free trade, in his classical passage on this subject. (For the *practical difficulties* of this argument, refer to page 267).

[The argument was first advanced in the United States in the early part of the nineteenth century and it was carried from the United States to Germany by Friedrich List, its best known advocate. Germany and the United States have now large and flourishing manufactures and so they no longer rely on the infant industry argument—they have now other arguments for protection. For India, with her undeveloped manufactures, this argument is much used.]

List's infant industry argument. Taussig and Marshall on the infant industry argument and on diversification of industries.

[List and other advocates of nurturing protection hold that protective duties for this purpose (a) should be moderate, (b) on manufactured

commodities only and not on agricultural commodities or raw materials and (c) should be temporary. "The duties should be moderate because an industry really suited to the country would not require heavy protection. And he holds that in the manufacturing industries only there is a chance of bringing about the establishment of new industries by a judicious policy of temporary protection.

The infant industry argument takes (a) a special (b) a more general form.

(a) *In its special form, it advocates temporary protection for special, selected industries which are specially suited to a country because of the existence there of an abundant supply of raw material or because of the aptitudes or necessities of the people.

(b) List has advocated however a more general form† of the infant industry argument. According to him countries pass through definite

* "The only case in which, on mere principles of political economy, protective duties can be defensible, is when they are imposed temporarily (specially in a young and rising nation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. . . . But the protection should be confined to cases in which there is good ground of assurance that the industry which it fosters will after a time be able to dispense with it" (Mill—Principles).

† "Finally history teaches us how nations . . . may and must modify their systems according to the measure of their own progress: in the first stage, adopting free trade with more advanced nations as a means of raising themselves from a state of barbarism, and of making advances in agriculture: in the second stage, promoting the growth of manufactures, fisheries, navigation, and foreign trade by means of commercial restrictions; and in the last stage after reaching the highest degree of wealth and power by gradually reverting to the principle of free trade and of unrestricted competition in the home as well as foreign markets, so that their agriculturists, manufacturers and merchants may be preserved from indolence, and stimulated to retain the supremacy which they have acquired." (List—*The National System of Political Economy*, Book I, Chap. X).

List's central doctrine is Nationalism. "I would indicate, as the distinguishing characteristic of my system, NATIONALITY. On the nature of nationality, as the intermediate interest between those of individualism and of entire humanity, my whole structure is based." List's system is essentially the national system of political economy.

And he has done useful service by emphasising the importance of immaterial capital and productive powers—as distinguished from material capital and material wealth. "The main use of protection is to promote the growth of productive power in all the departments in which the nation has the requisite natural resources. . . . On List's view there is no real opposition between free trade and protection, because neither is an end in itself, but simply a means to achieve a certain end, namely, the greatest development of productive power. . . . If, therefore, a sacrifice of value is caused by protective duties, it is made

stages in the history of their industrial development and protection is necessary to enable a country to pass from an agricultural stage to the manufacturing stage.

During this stage of transition from the agricultural to the agriculture and manufacturing stage, protection is necessary for almost all the industries in the country. When the country has fully attained industrial development, then protection should be removed and a policy of free trade should be established.

In the agricultural stage a country benefits by having free trade, and also it requires free trade when its manufactures have grown up. A policy of temporary protection is wanted only during the stage of transition to start new industries in the country and to protect them from being overwhelmed in their infant stage by unrestricted competition of the developed industries of foreign countries.

A criticism of the infant industry argument by free traders pointing out its *practical difficulties* is given later on.]

Taussig.

In discussing valid arguments for Protection, Prof. Taussig lays the chief emphasis on the young industries argument—and he extends it. List says that the argument applies only to backward countries. According to Taussig, it is applicable not only to new and backward countries but “points to some possibilities of ultimate gain,” even in the case of developed industrial countries. List advocates moderate duties. Taussig points out that there are instances in which new industries have been successfully established in a country not only by moderate duties but also by heavy protective duties and an illustration is supplied by the silk manufacture in the United States.

good by the gain of a *power of production*, which not only secures to the nation an infinitely greater amount of material goods, but also industrial independence in case of war. . . . List also insists on the importance, from the standpoint of national productive power, of the development of both manufactures and agriculture, as indeed of all industries, for which the nation is by nature adapted. Although the corner stone of List's system is nationalism, his ultimate idea is universal free trade The system of protection was the only means in his view of bringing other nations to the stage at which universal free trade would be possible and desirable. . . . The problem with List was to show the nations how they might upset this commercial overlordship and attain to an equality with England. The only method seemed to be that of temporary protection.” (J. S. Nicholson's introduction to Lloyd's translation of List's *National System of Political Economy*).

Marshall.

Marshall also recognises that there are elements of strength in the infant industry argument. He criticises some of the other economists, points out that they fail "to allow for the special circumstances of the new countries" and that they are wrong in regarding as identical the two statements—"the commodities which a country can *now* produce most easily" "and the commodities which a country has the greatest *potential* advantages for producing." He concludes that there is a valid "ground for intervention by the state in favour of nascent manufactures under the particular circumstances of time and place." And he extends in interesting fashion the scope of the expression "new countries"—"A country, which has been regarded as old, may become in fact new almost suddenly, for the great body of its people may awake to the attractions of modern industrial methods; and apply them energetically to rich natural resources, which have hitherto lain almost dormant. Japan has become new in this sense during the present generation: India, China, Siberia and Brazil, with much larger resources may become new ere the present century has passed."

(11) * Protection as a permanent policy—Protection for agriculture in Germany, Protection for manufactures in the United States.

List advocated protection as a *temporary measure*—and for the infant manufacturing industries of a backward country. Agriculture and the manufacturing industries are highly developed in Germany, in the United States—certainly they are not infant industries. *And in modern Germany, in modern United States, protection is now demanded as a permanent policy for securing the well-rounded economic (and other sorts of) development of the people.*

In Germany, France and other European countries before the War, protection was demanded and obtained for agriculture against imported agricultural products from the United States etc.

German protectionism was partly economic, partly political and social. "The maintenance of a capable German agriculture

* For the "Agrarstaat and Industriestaat" controversy in Germany, see Taussig, *Principles* and Ashley, *Modern Tariff History*.

means the maintenance of the German people now and for the future." (See pages 263-264).

The chief economic argument was that German exports of manufactures to foreign countries in return for imports of food and raw materials could not continue for ever; sooner or later the foreign countries with increasing population and manufactures would require all their own food and raw materials. Therefore Germany must depend on herself and must protect German agriculture. Protection of German agriculture by taxing imports of foreign agricultural produce will increase the cost of food and raw material in Germany. But the nation should cheerfully pay this price and in addition to its powerful manufactures and other industries secure a flourishing agriculture and a large and prosperous agricultural population—many-sided economic development and great military strength based upon a sturdy farming class. In the United States, it is stated by certain writers and thinkers that permanent protection will stimulate industrial progress and will benefit all classes—"a variegated industry is undoubtedly a sign of progress, and to the extent that it denotes a more efficient utilisation of labour and capital and a help to enterprise, it will result in higher wages as well as greater profits, a better standard of life for the workman and a more prosperous condition for the manufacturer. Even if domestic prices are higher than those of foreign goods, the loss to the individuals as consumers is more than offset by the gain that accrues to them as producers and participants in the general prosperity." This is sometimes called the "variegated production" (or diversification of industry) argument.

(12) *Conservation of natural resources like coal and other important minerals* This is often to the ultimate gain of the country, and reasonable protection for this purpose is a reasonable policy.

II. Non-Economic arguments in favour of protection.

A country may not find protection necessary from an economic standpoint. Protection may even injure the economic

interests of the country ; but the policy of protection should be adopted if political gains* (*national political strength, national self-sufficiency in war time etc.*) and other non-economic gains (*social development and progress*) from such a policy outweigh the economic disadvantages of protection.

(1) An argument which has found some measure of support is this—*protection promotes nationalism*. Protection against foreign competition binds the different parts of a country by common economic interests and thus strengthens national feeling among the people.

[This argument is not a decisive one, nationalism can be promoted in other and by better ways than by protection.]

(2) A nation should be independent of other nations as regards the supplies of military materials, e.g., cannons, rifles, ammunition, etc., for foreign supplies

Protection necessary for war industries. may be absolutely cut off or largely interrupted by wars ; and so industries for the manufacture of war materials should be established and maintained by protection if required.

(3) **Diversification of industry argument.** The economic side of the diversification of industry argument has been noticed already: (See pages 261-262). Diversification of industries to be brought about by protection has been advocated also on (a) *social grounds*. *Variety of occupations makes possible the all-round development of the physical and mental faculties of a people*, it brings about a rich, intense, organised and progressive social life.

(b) *Political grounds*. *Diversification is also necessary for national industrial self-sufficiency and the resulting political safety during times of war.* (i) A nation weak in agriculture,

* The classical passage on this point is that of Adam Smith and it is very frequently quoted.

Referring to the political importance of the Navigation Act for the navy and national defence of England, Adam Smith remarks: "*As defence, however is of much more importance than opulence the act of navigation is, perhaps, the wisest of all the commercial regulations of England.*" (*The Wealth of Nations*—Book IV, Chapter III).

and dependent upon food supplies from foreign countries. (ii) Or a nation having one or two chief industries, and depending upon foreign markets for the sale of the products—these nations, if they are cut off by wars from foreign countries, will suffer terribly economically and even may be politically ruined due to starvation and may be starved into submission by a powerful enemy having control over the great sea routes. The dependence upon foreign countries should be reduced by diversification of industries within the country.

[Protection for agriculture has been advocated in England on the ground that it would make England less dependent upon foreign supplies of food. In Germany, before the war, protection to agriculture was urged by one group of protectionists, partly on the same ground, and partly because it was thought that an agricultural population would be better military and social material than a manufacturing population.

The last European war has shown that the industries indispensable for the safety of the country include not only weapons and production of food, but also many other industries which help directly or indirectly to feed, clothe, equip and keep in a state of general efficiency millions of men in arms. Almost every occupation helps to some extent in national defence, a very extended scheme of protection may thus become necessary for countries which will be deprived of foreign supplies by a great war.

The strength of this argument for protection comes from the present state of international relations.]

(4) Professor Patten argues that protection helps to promote a higher civilisation specially in dynamic (*i.e.*, progressive) societies like the United States with extensive natural resources.

Protection is thus much more than a mere economic expedient. It is an agency and a valuable agency for the development of a higher civilisation. Prof. Patten is however too subtle for the average man, and his argument is taken as a form of the wages argument.

Arguments of advocates of free trade.

Among economists free trade has powerful supporters though under present world conditions the doctrine has lost a considerable amount of its hold upon politicians and upon the mass of the people.

The arguments which are advanced in favour of free trade are not all equally strong, indeed some of them are almost as foolish as the weakest arguments in the armoury of the cruder protectionists.

We begin with the refutation of these weak and unscientific arguments ; and then we shall consider the really strong arguments in favour of free trade.

I. Some unsatisfactory Free Trade arguments.

- (a) There are some free traders who declare that protective duties violate the natural right of a man to buy and sell where he pleases and so free trade should be established.
- Protection violates 'natural rights'.

Now this argument from natural rights is absolutely untenable because no such natural rights exist. The question as to whether a country is to follow free trade or protection is not to be decided by a reference to imaginary natural rights but from the standpoint of the general welfare of the whole country.

- (b) Certain uncritical free traders maintain that free trade should be followed and protection avoided because protection means socialism. The word socialism should not however frighten us, we should be ruled by facts and not by words. When protectionism is really advantageous to a community, it should be adopted without the least measure of hesitation.

II. The real case or arguments for free trade. The Rationale of Free Trade.*

The *really strong arguments* for free trade are those which show (A) that free trade confers positive advantages on a country (B) that protection does not in actual fact realise the beneficial objects which it attempts to accomplish or that these objects

* "In every particular exchange there is necessarily a gain to each party concerned; but the sum-total of exchanges is composed of the several particular exchanges, which have been made; and as each of the latter implies a gain, the immediate result must be beneficial. As the aim of protective duties, on the other hand, is to hinder exchanges, they are necessarily injurious. This brief statement contains the main

may be realised by means other than protection, (C) *that protection injures national interests* in certain respects and so the adoption of free trade is the only alternative.

(A) The positive advantages resulting from free trade.

The general argument in favour of free trade follows from the principle of division of labour,—free trade enables each country to devote its capital and labour to those industries, for which it has the greatest natural advantages and the best aptitudes; and so each nation attains a maximum industrial efficiency; and the industrial efficiency of the world as a whole is thus greatly increased. These nations trading with one another all benefit one another by their mutual exchanges (though in an unequal degree).

(B) Protection does not realise its aims.

(1) The idea that protection protects labour and raises wages has been subjected to examination and has been refuted.

High wages are due generally to high efficiency of labour and not to protection. If domestic labour is to be really protected, it would be better to prevent the importation of labour rather than the importation of commodities.

(2) The view that protection secures at the same time large revenue for the government and also protection for domestic industries is not generally well-founded.

point of the free trade argument." (Bastable—*Theory of International Trade*).

"International trade is like internal trade; the freer it is, the greater are the advantages to both parties. . . . By allowing trade to be absolutely unfettered, every one is able to buy in the cheapest and to sell in the dearest market, and the gains of all will be at a maximum. Every nation will thus be in a position to develop its natural advantages to the utmost, and the world's wealth will be enhanced because of the distribution of productive energies in the most economical fashion." (Seligman—*Principles*).

(B) Criticism of the infant industry argument.

Free traders admit that theoretically the infant industry argument for protection is a strong one, advocating as it does temporary loss in the shape of increased prices for consumers etc. for the sake of a larger ultimate gain in the shape of the establishment of new industries in the country ; but they point out the following practical objections and difficulties against the infant industry argument.

These infant industries never grow up ; they always remain infants. When some of the industries by protection have actually grown up and become strong enough to fight against foreign competition even then they would say that they have not grown up and they would clamour for the continuance of protection. It is difficult to withdraw protection once given and temporary protection tends to become more or less permanent.

Temporary protection under the infant industry argument is properly given when it is given to really suitable industries and given for a fixed and temporary period (and not indefinitely) and when the ultimate gain would be large enough to outweigh the temporary loss due to protection.

In actual practice, however, all these considerations are not carefully borne in mind by a Government granting protection and so the losses from protection are often greater than the gains.

(C) Protection produces certain serious evils and this makes the adoption of free trade necessary and desirable.

There are more things in earth than are dreamt of in the ordinary protectionist's economic philosophy. The ordinary protectionist does not often realise that protection has its serious evils.

The evils of protection are the following :

I. Economic evils.

(i) Protection in a country diverts labour and capital from.

those industries which are naturally more productive to the artificially protected industries. It thus

Production made less efficient by protection. reduces the industrial efficiency of the nation and makes it less productive than it would be under a system of free trade.

(ii) Again if protective duties are levied upon the raw materials for manufactures, upon machinery and other equipment for industrial enterprises, then the home industries will be heavily handicapped in their competition with foreign industries.

(iii) It has been ascertained that protection fosters the growth of monopolies and trusts by shutting out foreign competition. *Indeed it has been said that the protective tariff is the mother of trusts in the United States of America.*

Protection fosters monopolies and trusts. At least this much is true that if there had been no protection then international competition would have been a very effective instrument to use against the trust and to reduce its powers for evil.

This is a danger to be guarded against also in India.

(iv) Protection by weakening or removing altogether foreign competition slackens the spirit of industrial progress among home producers, tends to make

Business enterprise and industrial progress slackened. them less energetic and enterprising. *This is a great danger specially in a conservative country like India where the enterprisers are generally timid and unenterprising and unwilling to introduce quickly modern improvements in methods of production and business organization.*

(v) The import duties, under a system of protection, raise the price of imported commodities and also the prices of corresponding commodities manufactured within the country ; and the loss to consumers in the shape of increased prices is much greater than the revenue realized by the government.

Consumers suffer.

(This is an important consideration in India where millions

and millions of consumers are in wretched poverty and on the brink of starvation).

(vi) *From the standpoint of distribution* protection is unjust. It enriches producers who are rich at the expense of consumers, a great majority of whom are poor.

(This is also an important consideration in India).

(vii) *From the commercial point of view*, protection is undesirable. A policy of protection brings about a reduction in imports and this will bring about a reduction in exports so the export industries will suffer.

Labour and capital engaged in export industries will be injured by the reduction of employment.

II. Non-economic evils.

1. Actual experience in the United States has shown that *protection endangers the political morality of the people*. Large industries controlling enormous amounts of capital will bribe legislators to retain the existing amount of protection or to increase it.

This danger also exists in India, perhaps all the more so because the vast majority of the Indian people are unorganised and without education and are therefore unable to safeguard properly their economic and other interests.

2. Tariff wars between nations embitter international relations and have been known to lead to wars.

India and Protection.

Every country has its own problems of international trade.

Protection is necessary in India for some industries (chiefly infant industries) but only with sufficient precautions and suitable instruments. For India, the large loss to consumers, the question as regards the distribution of wealth, the conservatism of the Indian people as regards methods of production, the danger of monopolies and trusts and combinations among producers for exploiting the consumers, the danger of political and commercial immorality, have to be weighed against any possible

advantages from protection (Refer to pages 257-264; 466-469). The Indian Government is fairly efficient; but it is bureaucratic, not sufficiently responsible to Indian public opinion, not sufficiently businesslike and it is controlled by the British democracy at home—and as at present constituted, this government is not the fittest instrument for introducing protection, specially when the question is between Indian and English industries and the protection of Indian industries against the competition of English industries. *India must have the substance of Swaraj or responsible government controlled mainly by Indians and responsible to the Indian people and then only India will be able to introduce a really satisfactory and scientific system of protection for Indian industries.* 11

Under the pressure of public opinion, beginnings have been already made as regards the introduction of protection into India. *The Indian Fiscal Commission has recommended discriminating protection**; and it lays down the following three conditions to be satisfied by industries before protection can be granted:

* The phrase 'discriminating protection' was the Hon'ble Mr. Har-kishenlal's gift to the Indian Fiscal Commission. Prof. Coyajee gives an able exposition of "discriminating protection" in his *Indian Fiscal Problem*. "If one is asked for a description or definition of "discriminating" protection, the answer is that it is based upon and guided by the principle of comparative cost. In other words it extends protection only to such industries as regards which a country enjoys or can be shown to enjoy ultimately a comparative advantage. . . . We have in fact reached the central principle which can guide us aright at all points—as regards the industries to be selected for protection, the extent and measure of assistance to be extended to them as also the length of the period during which such help is to be rendered to them."

Such "discriminating" protection secures national productive efficiency and it is also in the interests of the consumers, making protection and its burden of high price temporary and the least possible.

In connection with Indian protection, Prof. Coyajee recognises that the diversification of industries argument is no less important than the infant industry argument. "In advancing and marshalling the arguments for protection the Indian Fiscal Commission has justly given the place of honour to the infant industries argument. Not only is the theoretical validity of the argument undeniable but there has been a tendency to extend the scope of its application on the part of recognised economic authorities (Taussig, Marshall, etc.) . . . We might now turn our attention to the other cogent argument on behalf of protection—that for the diversification of industries. . . . It might have been

(1) The industry must be one possessing natural advantages, such as an abundant supply of raw material, cheap power, a sufficient supply of labour, or a large home market.

(2) The industry must be one which without the help of protection either is not likely to develop at all or is not likely to develop so rapidly as is desirable in the interests of the country.

(3) The industry must be one which will eventually be able to face world competition without protection.

A Tariff Board (like similar Boards in the United States and Australia) has been constituted ; it is

(1) to investigate the claims of particular industries to protection, and if satisfied that protection is required, to recommend the rate of protective duty, or any alternative measures of assistance such as the grant of bounties,

(2) to watch the effects of protective duties or other measures of assistance on industries ; to review periodically the results of such protection on each industry, and to make recommendations when necessary for the modification or withdrawal of protection etc.

noted that the two arguments—the infant industry argument and the argument relating to diversification and correlation of industries—are closely related one relating to development and the other to the co-ordination and co-operation of productive powers. The development of any particular infant industry is one means and aspect of securing the requisite national co-ordination of industries. But in looking at diversification or co-ordination of industries, our viewpoint is shifted to the national outlook embracing all industries and to their interrelations. . . . This wide range of the diversified industry argument imports into it considerations relating to all aspects of protection—social, psychological and industrial. . . . The principle of comparative cost defines the scope of wise diversification of industry."

The diversification of industry (or 'variegated production') argument—now enjoying a substantial measure of support in Germany and the United States—has in India a long and renowned history. In Germany the protest has been against neglect of domestic agriculture and excessive attention to manufactures for export. In India the emphasis has been in the opposite direction—against neglect of manufacturing and other industries and excessive dependence on agriculture. And the argument is powerfully stated in the writings of the late Mr. Ranade, the late Mr. R. C. Dutt; it is forcefully presented by Pandit Malaviya and other living Indian publicists of recognised standing.

The Tariff Board is not to take decisions, it is to make recommendations—and the final decision rests with the Indian Government and the Indian Legislature.

Protection has been granted to the steel industry and the paper industry and certain other industries. The steel industry is protected by (1) import duties on foreign steel products and also (2) a direct bounty to the Indian steel industry.

• **Dumping, Retaliation, Reciprocity.**

For dumping and the different kinds of dumping, see Part I., Book Fourth, Chapter VI, Page 415.

Under modern conditions of industry, producers often find it desirable to sell the surplus stock in foreign countries at excessively low prices thus keeping up prices in the domestic market when it is their chief market.

The advantages from dumped goods.

Some writers maintain that the foreign country in which the goods are dumped is sometimes benefited than otherwise.

The consumers of the country get dumped articles at cheap prices and manufacturers will get their raw materials cheap if these are dumped into the country.

The continental countries which dumped bounty-fed sugar into England at extremely low rates enabled English consumers to get their sugar for almost next to nothing.

When does dumping injure? Protection against dumping.

Under other circumstances dumping is injurious to the country in which the dumped goods are sent. Russia wants to develop her iron industries, she wants to make her own rails. And the dumping of cheap German rails into Russia will be prevented by Russia in the interest of her own industry.

Protection against dumping is thus desirable under certain circumstances. This is an important protectionist argument.

The *practical difficulties* in connection with the prevention of dumping are however considerable.

Reciprocity or Fair Trade.

This is to be distinguished from Free Trade. According to the strict principles of Free Trade, a country should allow the imports from a foreign country to come in freely even if the foreign country levies protective duties against that country.

The advocates of Fair Trade (as opposed to Free Trade) maintain that a policy of Free Trade should be adopted in the trade with Free Trade countries and that against protectionist countries a protectionist policy should be followed. There should be reciprocity in the matter of trade. (In answer to this, free traders point out that if a free trade country in spite of protective taxes levied by other nations on her goods, can get the goods of other countries in exchange for her own goods at less cost than she could make goods like them for herself, it was in her interest to do so).

Retaliation.

The advocates of Retaliation recognise the advantages of Free Trade. They look upon Free Trade as the ultimate goal; and they support retaliation as a temporary policy to compel foreign nations to reduce taxes on imports from the home country and thus bring about Free Trade.

As soon as the foreign countries have been brought round, retaliation would be dropped and the policy of Free Trade should be established.

Retaliation has been supported by* Adam Smith, and it is powerfully supported by some modern economists including Gustav Schmoller.

Objections against a policy of Retaliation.

(1) Opponents of retaliation point out that historically measures of retaliation have generally failed to produce the desired effect.

(2) Retaliation may provoke counter retaliation and thus lead to endless economic warfare.

(3) It is difficult to adopt measures of retaliation against the trade of a foreign country in such a way as to avoid a corresponding injury to the home country. Restrictions on such foreign imports as will seriously injure the foreign countries will also generally be felt seriously by the purchasers of these imports in the home country.

It is to be carefully remembered that *retaliation is to be justified only from the point of view of free trade*. It is successful only if it succeeds in bringing about free trade, otherwise it is completely thrown away.

* "*There may be good policy in retaliation of this kind, when there is a probability that they will procure the repeal of the high duties or prohibitions complained of.*" Adam Smith goes on to point out that to judge whether such retaliations are likely to produce such an effect, does not, perhaps, belong so much to the science of a legislator as to the skill of "that insidious and crafty animal vulgarly called a statesman or politician."—(*The Wealth of Nations*, Book iv).

† Conclusion about Free Trade and Protection.

An examination of free trade and protectionist arguments leads to these conclusions.

The problems of international trade are problems partly of national, partly of international organization. Free trade progresses during times of peace and Protection during times of war between nations.

† Free Trade is not the suitable policy for all nations and at all times. Nor Protection. Whether a nation is to follow Free Trade or Protection depends on its state of development—on its economic, political and social conditions. And the same nation is justified in adopting Protection at one stage and Free Trade at another. Protection has its uses. Also Free Trade.

This is the opinion maintained in modern countries—Germany, Britain, France and the United States, etc.—by the leading economists of the present generation. Germany under existing conditions requires protection—perhaps moderate protection. And Schmoller, the famous German economist of the historical school, declares that “neither free trade nor protection is to be blamed but the misuse of either and the employment of either policy under unsuitable circumstances.” Till recently Britain was a great free trade country. And Prof. Marshall, the great leader of the English free trade economists, carefully notices the exceptions and qualifications to free trade and states “in the long run it might have been better both for England and for free trade if they (the old English economists) had been compelled to make prominent the cumbrous qualifications which they omitted.”

The United States of America is a stronghold of protection. Prof. Taussig, a distinguished American economist, thus outlines his position: “I would not have the reader to infer that I am an unqualified free trader. . . . *The case in favour of free trade* has indeed always seemed to me *prima facie strong*; and prolonged investigation and reflection have served to confirm me in this opinion. But it is *only a prima facie case*. There may be offsetting advantages which rebut the presumption.”

As regards Protection, Prof. Marshall recognises the strength of the infant industry (*nascent industry*) argument and the diversification of industry argument; Prof. Taussig values the young industries argument, does not consider the argument from diversification of industries under protection applicable at least in the case of the advanced nations, but he realises the effectiveness of “political and social arguments as to the avoidance of extremes”—and admits the utility of protection against dumping.

Prof. Seligman makes the following observations as regards the history of protection in Britain and the United States: “It was in England that the system (of protection) was carried to an extreme, and it was there that the reaction first came. During the period of the industrial revolution which, as we know, began in England several

Between nations which are now in a state of comparative economic equality, on economic grounds free trade is the best policy, and protection is unnecessary and even injurious. Even such nations may find protection necessary on political grounds.

At the present moment all nations are not in a state of comparative economic equality. Some nations are backward, others are very much advanced from the industrial point of view. Free Trade between an advanced and a backward nation*

decades earlier than elsewhere, Great Britain followed a policy of the most rigorous industrial protection. Not only were many of the import duties quite prohibitory, but the export of machinery or even of the plans of machinery was absolutely forbidden. Compared with the British tariffs at the end of the eighteenth and the beginning of the nineteenth century, even the most complex of modern tariffs is simplicity itself. When Great Britain had finally attained a virtual monopoly of the chief industries and had established her supremacy on the ocean, she naturally found it to her interest to let down the bars. Not fearing foreign competition any longer at home, her great need was to secure an outlet for her surplus products. (In England) Free Trade was now an accomplished fact.

For a short time the free trade movement made some headway in other European countries. With the revival of the national sentiment, however, first in Germany and Italy and then elsewhere, the last quarter of the nineteenth century witnessed not only a return to, but an intensification of protection. Finally as the younger industrial nations are attaining their maturity, Great Britain is commencing to lose her proud position of complete industrial domination, and we accordingly find since the beginning of the twentieth century in the classic home of free trade itself a sharply defined movement for a return to protection.

So far as the United States is concerned it is scarcely open to question that the system of protection has somewhat hastened the industrial development of the country. It has not created the development which was bound to come sooner or later, and it is responsible for many incidental evils (political demoralization, monopoly, etc.). . . . And it is yet difficult to escape the conclusion that protection has been on the whole a wise policy for the United States. . . . As the United States becomes more and more an industrial nation, seeking an outlet for its manufactures, it is indeed probable that the tariff will be gradually lowered, with advantage to all, but he would be a hasty prophet who would predict any sudden or material change for a considerable time to come" (Principles).

** The rationale of protection—in its economic aspect—is thus stated by Prof. Coyajee in his Indian Fiscal Problem: "The correct theory of protection is based upon the unfulfilled assumptions and necessary qualifications of the native free trade theory. The benefits of international division of labour are no doubt great; but it is only when fully developed countries compete as equals that the best form of international division of labour can be reached, and such a division is*

will benefit the industrially advanced people, and will benefit the world as a whole for the time being at the risk of serious loss to the backward people.

"The essence of free trade is cosmopolitanism ; the essence of protection is nationalism."

A nation may rightly follow a protective policy and impose restrictions on international trade—

(1) *To promote national economic interests.* A backward nation is justified in hastening its industrial development by protecting suitable infant industries till they reach maturity.

As Prof. Marshall says "Protection to immature industries is a very great national good."

(2) *To promote national political interests.*

Some nations may require protection (a) to promote national political interests and also (b) to promote national economic interests and industrial development ; and some nations may require protection to promote national political interests only, not requiring protection to promote national economic interests because the industries in these nations are already developed and progressive.

"Defence is better than opulence." National strength and national independence are to be secured sometimes even at the sacrifice of economic interests.

(a) Protection for industries engaged in making guns, munitions and other war materials and (b) protection for promoting national industrial self-sufficiency to the required extent in view of interruption of communications with foreign countries during a war—these are justified on this ground.

(*Protection against dumping* is defensible when such protection is necessary to prevent the imported dumped goods from injuring domestic industries by unfair competition. Res-

itself reached only by tentative stages. . . . Finally, the transfer of capital and labour from one industry to another, as a result of the stress of foreign competition, is a much more formidable matter than has been sometimes supposed. *The unfulfilled assumptions and the unemphasised qualifications of free trade form the armoury of protection.* In the considerations stated above might be recognised the leading arguments for protection.

trictions on international trade in the shape of *retaliation* are justified if such restrictions are likely to induce the foreign country to lower its import duties on the goods of the country adopting a policy of retaliation).

Certain general considerations on the subject of Free Trade and Protection.

Whether a country follows a policy of free trade or protection is a question to which sometimes too much importance has been attached. This question is not after all of vital importance especially in rich and progressive countries inhabited by an intelligent and enterprising people.

We see the United States has prospered under protection and so also Germany; and England has prospered under free trade.

* *The tariff policy of modern countries has undoubtedly been a minor factor in their industrial life.* Industrial prosperity in the United States as well as in England and Germany is principally due to the spread of general and technical education, the development of intelligence and ambition among the people, scientific inventions and discoveries, up-to-date machinery and up-to-date methods of production and business organization—and not due only to free trade or protection. A country with an intelligent, enterprising and wealthy population possessing the modern material equipment for production (viz. abundant natural resources, adequate transport and banking facilities etc.) will prosper under free trade and sometimes will prosper even in spite of protection. And it has been seen already that protection also is necessary sometimes to secure national economic or political interests.

* "A last lesson may, perhaps, be learned from the considerations of British trade policy during this period; that questions of trade policy by themselves have not the primary importance they are generally assumed to have, and that to-day, they fall relatively into the back ground as compared with the great problems of the national organization of production and labour". (Fuchs—*The Trade Policy of Great Britain*).

Also Taussig—*Principles*, Vol. I., Chap. 37.

Was the English policy of free trade followed by other nations?

England gradually changed her policy of protection to one of pure free trade by successive steps in the period from 1815 to 1860.

Other European countries did not at first follow the English free trade example because they thought that the sudden influx of British manufactures would ruin their infant industries which had grown up under the continental system and the exclusion of British manufactures.

From about 1850 to 1865 there was a distinct tendency towards free trade in almost all European countries, France, Germany, Italy, Holland, Belgium, Portugal etc.,—they all adopted measures in the direction of free trade.

A protectionist reaction has been in operation since 1865 and this has prevented the continental countries from following in the footsteps of England. The causes of this renewed movement in favour of protection are the following :—

(1) Wars have increased national hostility and have thus strengthened the desire for protection.

(2) Wars are costly. Large revenues have to be raised; and financiers have found it convenient to resort to protective duties for this purpose.

(3) Agricultural depression in Europe, and the importation of cheap foreign food specially from the U. S. A. have led to a demand for agricultural protection in the agricultural countries of Europe.

Wars increase the desire for and to some extent also the need for protection.

The World War and the World Economic Depression have strengthened economic nationalism among nations.

The World War of 1914-18 greatly increased the desire for protection in almost all countries and largely strengthened the spirit of economic nationalism. The movement towards economic nationalism has been further strengthened by the world economic depression. Britain, the leading free-trade country of the world, has been compelled to abandon free trade and to adopt a policy of protection against foreign countries and as a result of the Ottawa Conference, the policy of Imperial Preference as between the countries of the British Empire.

Economic Nationalism, its Evils and its Future.

The world economic depression has brought about large and disastrous changes in prices, production, employment—and not less in international trade. The tendency is now all

towards economic nationalism,—each nation trying to be a self-contained economic unit as far as possible, reducing foreign imports by heavy protective tariffs (a) partly to help domestic industries hard hit by the depression, and (b) to reduce foreign obligations which may depreciate the external value of the domestic currency, also (c) to secure revenue for improving the financial position of the government in a time of exceptional financial difficulty.

Economic nationalism of an extreme type is known as *autarchy*.

“The conclusion to which the world will move, if the “closed unit” alternative is chosen, will be that of an economic system in which either single great countries, like the United States or Russia or Empires such as British, or economic unions of a number of separate politically sovereign states, for example in Central Europe,* will form economic units, each producing from its own resources for its own market, with no more than an indispensable fringe of external trade as a supplement. Raw materials will be exported and imported; a few highly specialized manufactures will pass from one unit to another. The position will become more like that of the days before the industrial revolution, when with small unit manufacture and primitive transport facilities the vast bulk of the world’s activities were national, or even regional and local, and external trade was mainly concerned with the precious metals, the precious spices, a few luxuries, a few staple commodities such as wool and its products”—Sir Arthur Salter in *Foreign Affairs*, October, 1932.

The evils of economic nationalism. Failure of the World Economic Conference (1933) to achieve substantial results.

If this kind of economic nationalism continues and becomes even more aggravated in future, the result will be that every nation will be impoverished by turning its labour and capital to comparatively unproductive channels for making, at comparatively high costs, many things within the country which could be imported more cheaply from foreign countries where they are made cheaply and efficiently. *The world as a whole*

will thus get impoverished and mankind will have to accept a lower standard of living. This great menace to the economic well-being of the world can be averted only by international co-operation for reducing economic nationalism and promoting international goodwill. But unfortunately the signs of such co-operation are still few and not sufficiently promising. The World Economic Conference, held in 1933, has failed to achieve anything substantial in this direction.

The Ottawa Conference and Agreements.

The Ottawa Conference is an experiment in economic nationalism for the British Empire. The value of the agreements arrived at between Britain, India and Britain's self-governing colonies has been much disputed by competent British and Indian economists.

(1) It is pointed out by competent economists that these agreements, so far as they do not expand the world trade, so far as they do not bring about an increase in the total value of world's trade,* they will not add to the world prosperity and to the prosperity of the British Empire which is a part of the world economic system. A mere diversion of trade from non-empire countries to countries within the British Empire is no net gain to the world. It may mean loss by diverting labour and capital to comparatively unproductive channels.

(2) Further the Ottawa agreements do not secure Empire Free Trade nor even low tariff Empire trade, and thus do not promote materially more economic and efficient application of labour and capital within the countries of the British Empire as a whole.

(3) As regards Britain Lord Snowden and certain other distinguished British economists and public men maintain that the interests of Britain have been sacrificed to the interests of British self-governing colonies. As the result of these agreements Britain will have to buy food and raw materials dearer

* "The principal conference at which tariffs have been discussed, that of Ottawa, does not increase the volume of world trade as a whole"
—Sir Arthur Salter, *Recovery*, 1933, xxix.

from Empire countries and specially the colonies without getting sufficient compensation for British manufactures in the colonial markets which are well-protected against British imports in the interest of domestic industries. Some British manufacturing industries have gained some advantages in the colonial markets from the Ottawa agreements. But British manufacturing industry as a whole has not gained sufficiently to make it worth the cost to the country as a whole.

Just now there is strong complaint by British farmers that the British colonies taking advantage of the Ottawa agreements are able to sell their agricultural products in Britain at prices which cause great loss to British farmers. Mr. Baldwin, the British Conservative leader, has been forced to take notice of this situation and has declared "the interests of our farmers must come first, the interests of the Dominions' farmers second, and the interest of the foreign farmers third."

India and the Ottawa Agreement.

The Ottawa agreement, entered into for India by a largely unrepresentative Indian delegation, has been ratified by a largely unrepresentative Indian legislature. The agreement has been strongly criticised by Indian opinion. It has been remarked that the delegation should have been more representative and should have been better prepared with facts and materials which would have been best supplied by a Fiscal Commission.

As at present arranged, the Ottawa agreement is highly unsatisfactory.

(1) A fundamental consideration of World Economics.

The Ottawa agreement with its *restrictive* effects will not increase the volume of world trade, will not help world recovery and to that extent will not help India which is a part of the world economic system.

(2) A fundamental consideration relating to Indian economic conditions.

For nearly a generation, Indian imports from Britain and British Empire countries have been decreasing and imports

from non-empire countries have been increasing, also Indian exports to Britain and Empire countries have been decreasing and Indian exports to non-empire countries have been increasing.

The object of the Ottawa agreement is to change artificially this present strong natural movement of Indian trade away from Britain and the Empire. * Broadly the result of the Ottawa agreement will be that (1) India will have to buy *now and in future* dearer imports from Britain and British Empire countries rather than cheaper imports from non-empire countries and (2) India will have to sell *now and in future* more exports in the unexpanding and comparatively unremunerative markets of Britain and Empire countries rather than in the more expanding and comparatively more remunerative markets in the non-empire countries.

* A good detailed examination of Indian exports and imports in this connection is found in D. Ghosh's *The Ottawa Agreement*. Without going in detail into different Indian exports and imports for an examination of the effects of the Ottawa Agreement, the following may be noticed :

(1) *Indian Exports.*

Indian exports, as a whole, do not gain substantially from British preference. There is some gain to certain Indian exports. Also as Indian exports are chiefly of food-stuffs and raw materials, Britain cannot exclude them from preference without much injury to her own economic interests.

(2) *Indian Imports.*

The agreement in its present form means large losses to the Indian consumer both now and in future in connection with Indian imports.

(3) *Indian Exports and Imports.*

The net gain to India's exports from Empire preference is much less than the net loss on Indian imports both now and in future.

Indian foreign trade statistics for 1932-33 show that Indian exports have not benefited by the Ottawa Agreement and that Britain, has benefited by a substantial increase of British imports into India. So what was expected by the critics of the Ottawa Agreement, has happened in actual fact.

As regards Indian exports of raw and manufactured jute, ground-nuts, rice, shellac, goat-skins, mica, forming about two-thirds of the total value of Indian exports (to all countries) affected by preference, India is not likely to lose much by rejecting Imperial Preference. For India is a monopolist supplier of some of these commodities, and as regards certain other commodities she has a sort of semi-monopolist

So the Ottawa agreement will mean for India loss *now* and *in future* in connection with both imports and exports.

Satisfactory International Trade Arrangements in relation to comparative cost.

It is clear that on purely economic grounds and as between nations in a state of comparative economic equality, free trade is the best policy. This appears from the doctrine of comparative cost. (In other

position among British-Empire countries. Also Britain cannot exclude India from Imperial Preference as such exclusion will lead to higher prices for certain food-stuffs and raw materials in Britain and that would be clearly against British interests.

Tea is an important Indian export to Britain. Indian tea (like all Empire tea) requires preference in the British market to maintain its position against Java and Sumatra tea. But this preference must be substantial. Also the benefit to India from preference granted to tea is qualified by the two following considerations :

(a) About 85 p. c. of the capital invested in the Indian tea industry is British capital, and so it is predominantly British capital which is getting preference.

(b) The preference in the British market granted to Indian tea is also granted to tea from Ceylon, another Empire country. So the position of India is not improved in any way in relation to Ceylon, a strong competitor of India, in the British market as regards tea.

Preference to British imports into India under the Ottawa Agreement is likely to increase prices to Indian consumers by shutting out cheaper imports from other foreign countries; in some cases, is likely to reduce protection to Indian industries and affect unfavourably the revenues of the Government.

It is pointed out that India's joining a scheme of Imperial Preference may lead non-empire countries, like Germany, France, Italy, U. S. A., Japan to retaliate against Indian exports to these countries. These non-empire countries are large buyers of Indian exports of raw cotton, oil seeds, hides and skins, pig iron and they always buy more from India than they sell to India. This danger of retaliation is substantial and must not be ignored.

India requires protection for her manufacturing industries and chiefly against British competition; and after safeguarding the interest of her manufacturing industry and at the same time avoiding undue burden on consumers in the shape of unduly high prices India can cultivate friendly trade relationship as regards exports and imports with Britain and Empire countries, and also with non-empire countries like Germany, France, U. S. A., Japan. But in these trade agreements, India's interests should be duly considered. The Ottawa Agreement, in its present form, does not give due consideration to Indian interests, leads to sacrifice of India's large and expanding (export and import) trade with non-empire countries in the interest of Britain.

cases and on economic as well as on political grounds, a policy of protection may be desirable for a country.)

Again when a country seeks scientific protection on economic grounds, the principle of comparative cost should determine what industries best deserve protection and the extent of protection and the duration of protection.

Even when economic nationalism (unscientific protection) is very much favoured by nations as at the present day, the economic losses due to it may be minimised if there be some regard paid to the principle of comparative cost in the selection of industries for protection.

The world factor in relation to present conditions of international trade.

The world factor in this connection is of the utmost importance. For a long period a country can continue to sell increasing quantities of its goods and services to other nations if it continues to buy increasing quantities of goods and services from other nations. If some countries follow a policy of restriction of imports against other nations, this brings about, sooner or later, a similar policy of restriction by other nations against these countries. Every country suffers. The world suffers as a whole. Mankind has to submit to a reduced production of wealth and to a lowered standard of living. This is the present condition of the world to-day. Every nation will live better by following a more liberal policy in its international trade with other nations. It must live with the world—not cut off from the world.

Summary.

1. International trade is trade among nations of goods for goods.
2. *International values* (the ratios of exchange between commodities entering into international trade) are determined by the intensity of reciprocal demand within the limits imposed by comparative costs. (International values are largely influenced by the fact that labour and capital do not move so freely from country to country as within the same country).
3. *(a) International trade has the following advantages*:—It enables a country to get by importation commodities which cannot be produced at home, also to get cheaply commodities which can be produced at home only at a greater cost, it develops a nation's industries by extending the market for them, increases the productive efficiency of all nations as a whole and acts as a powerful check on monopolies and

trusts. It makes for peace among nations and promotes culture and civilisation.

(b) *International trade has its disadvantages*:—Importation may displace labour and capital in domestic industries; and exportation increases the risks of overproduction, may intensify the operation of diminishing returns and may lead to the exhaustion of valuable natural resources.

4. *The balance of trade resulting from the imports and exports of commodities* is to be distinguished from the *balance of accounts* resulting from the total credits and debits of a country.

5. A wonderful economy of metallic money is made in payments in foreign trade through the use of bills of exchange and other credit devices.

6. *The rate of exchange* is determined chiefly by the demand for and the supply of bills. Strictly speaking, it depends upon the total reciprocal liabilities.

The specie points or gold points are upward and downward limits in the rate of exchange at which gold flows from country to country, and they are respectively (a) par value plus cost of transmitting bullion, (b) par value minus cost of transmitting bullion.

A so-called favourable rate of exchange is a rate which leads to the importation of gold; and a so-called unfavourable rate is a rate which leads to the exportation of gold.

7. Nations have at different times imposed restrictions on international trade with different objects.

Protection is defended on economic and also on non-economic grounds. On economic grounds protection is advocated as increasing employment, keeping wages high, developing infant industries, conserving natural resources, preventing dumping and by protective duties making the foreigner pay while at the same time protecting domestic industries. On non-economic grounds protection is advocated as promoting nationalism, securing national industrial self-sufficiency so often found necessary in times of war, and promoting a higher civilization in dynamic societies.

The principal arguments in favour of *free trade* attempt to show (a) that free trade confers positive advantages (b) that protection fails to realise its beneficial aims (c) that protection often produces serious evils.

[Free traders regard their arguments in favour of free trade as so many arguments against protection, and protectionists regard their arguments in favour of protection as so many arguments against free trade.]

8. The increase of *Economic Nationalism* is a danger to world economic prosperity.

9. The Ottawa Agreements are an experiment in Economic Nationalism as applied to the British Empire. In the present form of the Ottawa Agreement in relation to India, Indian interests have not been duly considered.

Questions.

1. What are the advantages of international trade, and what are the disadvantages? (C. U. 1921).

Discuss the advantages and disadvantages of international division of labour. (C. U. 1924).

2. (a) State the theory of international value. (C. U. 1925).

(b) Write a note on the analogies between domestic trade and international trade.

(Domestic trade within a country is based on *division of labour* and *secures important economies* from this division of labour. International trade *essentially* does the same thing—only on a larger scale, and as between nations. Different nations are regarded as non-competing groups as regards labour and capital. But there are non-competing groups also within the same country. So the analogy holds partly here also.

Seligman and certain American economists maintain that a separate theory of international value is not required—in view of the analogies between domestic and international trade.

Taussig notices the above-mentioned analogies between domestic and international trade. Also he states: "As between nations, so between social groups (within the same nation), the range of money incomes is the instrument and the decisive test of gain; and that gain is realised in the purchase of the thing or services produced by other groups"—(*Principles of Economics*, 1926, Vol. II., Chap. 48.)

3. Write notes on balance of trade, balance of accounts, invisible imports and exports. What is a favourable balance?

Give a brief account of the Mercantile Doctrine. (C. U. 1923).

For what different reasons may a country's exports habitually exceed or fall short of its imports? (C. U. 1928).

4. What is the rate of exchange? What is a par rate of exchange? Specie points? Favourable and unfavourable exchange?

Write notes on (a) the mint par of exchange (b) the specie points. (C. U. 1922, 1932).

Show how by means of a bill of exchange a sale of goods to a merchant in London, by a merchant in Calcutta, and a sale to a merchant in Calcutta, by a merchant in London, may be liquidated without the sending of specie from one country to another. (C. U. 1921).

Explain carefully how the rate of discount influences (a) the prices of securities and (b) the foreign exchanges. (C. U. Hons. 1931).

Refer to *The Rate of Discount* in pages 232-233.

How is a disturbance of the equilibrium between a country's credits and debits corrected? Consider separately the case of trade between countries which have (a) gold currency, (b) inconvertible paper currency.

Refer to *THE CORRECTIVES OF THE EXCHANGES* in page 230.

As between two countries on the gold standard, the disequilibrium is corrected by the manipulation of the rate of discount and the inflow of gold into the creditor country and the outflow of gold from the debtor country. But as between two countries with inconvertible paper currency, there is no free inflow and outflow of gold; and the disequilibrium between two such countries is corrected by the adjustment of the internal price levels in the two countries and the adjustment of the rate of exchange.

5. What is the theory of protection? Discuss the arguments, economic as well as non-economic, usually urged in favour of a protectionist policy in our day. (C. U. 1911, 1926).

6. Write a note on the infant industry argument pointing out its theoretical validity, and indicating practical difficulties.

7. State the main arguments for and against free trade. How do you account for the fact that other nations have not followed England in adopting the policy of free trade? (C. U. 1911).

8. Discuss some of the cases where limitations on the freedom of trade may be desirable. (C. U. 1912).

Discuss on what grounds it may be considered desirable to impose restrictions on the freedom of international trade. (C. U. 1922).

9. Summarise the principal arguments in favour of free trade and protection respectively. (C. U. 1923).

10. Discuss the arguments for and against protection as applicable to different countries at different stages of industrial development. Do you consider the adoption of this system desirable in India at present? (C. U. Hons. 1929).

11. Write a note on the Ottawa Agreement as affecting India.

BOOK V

Distribution.

CHAPTER I.

* What is distribution?

The word distribution refers to the sharing (distribution) of the income of society (national dividend or national income) among the agents of production, viz. land (meaning all natural agents), labour, capital and organization which co-operate in the work of producing that income.

* Mill attempts a distinction between the laws of production and the laws of distribution. "The laws and conditions of the production of wealth, partake of the character of physical truths. There is nothing optional, or arbitrary in them. . . . It is not so with the distribution of wealth. This is a matter of human institution solely."

"*Distribution, like production, is a social phenomenon.* If everyone consumed what he individually produced, there would be no exchange, no price, no distribution. In production we study the creation of the social income; in distribution we study its division. In the one case we regard it as the national output, in the other as the national dividend. . . . The modern science of economics is, as we have learned, due to the efforts to analyse the modern shares in distribution.

The study of distribution is primarily a study of the remuneration of the factors of production. . . . Among them, wages, interest, or rent and profits exhaust the entire social income.

In modern society differentiation of functions has proceeded to the extent that different classes control different agents of production. This separation, however, is not rigid. The same man may own land and factories; he may be a workman and a stockholder. . . . In the great mass of cases, however, the social class corresponds to a different kind of income, and in its broadest aspect the social shares in distribution correspond to the factors of production"—Seligman.

A contribution—interesting and important—has been made by Prof. Cannan to the theory of distribution.

"I even went so far as to entitle the inquiry into wages per wage-earner, profits per cent., and rent per acre "*Pseudo-distribution*," in contradistinction to "*Distribution Proper*," which I took to be theory about the proportions in which aggregate income is divided between classes and persons."

Production in a modern community is a social process. So is distribution.

"The economics of distribution is concerned with the *earnings* of the several agents of production, and the relation of these earnings to one another and to human effort." The share going to land is called *rent*, that going to capital is called *interest*, the share earned by labour is *wages* and that going to organizing is *profit*.

[There is some amount of difference of opinion among economists about the use of the terms rent, profits, etc. These difficulties are noticed and explained in their proper places in the course of this Book.]

The old conception, however, was deeply rooted and difficult to shake. *Marshall during this period seemed to move, if at all, rather backwards than forwards in this particular matter.*

Taussig, in his *Principles of Economics*, 1912, at the beginning of Book V: "The Distribution of Wealth," formally adheres to the old conception, but he shows some appreciation of the need for change by including a substantial chapter on "Inequality and its Causes."—Cannan, *A Review of Economic Theory*, 1929, pp. 301, 302.

"First, in the range of his constructive work, I should unhesitatingly place his treatment of the theory of distribution. He found in the books a thing which he justly called 'Pseudo-Distribution'; he created a theory of 'distribution proper'. He found economists pretending to discuss the distribution of wealth and actually discussing the causes determining wages per head, profits per cent., and rent per acre, which are simply three special cases of the theory of value. He found a confused discussion proceeding about distribution between factors of production and he not only straightened out, but laid the foundations of that much more interesting and directly important branch of the subject, distribution between human beings. . . .

. There was an unhealthy tendency developing in British economics to take existing institutions uncritically for granted, often not even to mention their existence and to concentrate on building up a non-institutional apparatus of marginal utilities, scarcities and costs of production, consumers' and producers' surpluses and long and short periods, an apparatus of ever increasing intellectual refinement but ever diminishing practical appeal. Prof. Cannan has done as much to reverse this drift, to revert sharply to the study of the institutions, to explore the economic foundations of society and not to flutter, as explanatory apologist, on the surface of economic phenomena" (Dr. Dalton's article in *London Essays in Economics in Honour of Edwin Cannan*).

What is distributed? The National Dividend (or National Income).

The capital and labour and organisation of a country working upon its natural resources in a fixed period of time (say, one year) produce a certain amount of commodities and services, and this amount is the National Dividend for the period. We get the National Dividend by subtracting the Replacement Fund from the money value of the gross produce of the society; the Replacement Fund is the fund required for repairing and replacing machinery, buildings, etc. The National Dividend is thus the net produce of the society in a given period of time.

Labour	Organisation	Land	Capital
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NATIONAL DIVIDEND

Wages	Profits	Rent	Interest
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* The National Dividend is at once (a) the aggregate net product of and (b) the sole source of payment for all the agents of production within the country. It is this National Dividend which is divided into—

- (i) Wages—the earnings of labour.
- (ii) Profit—the earnings of organizing.
- (iii) Rent—the earnings of natural agents.
- (iv) Interest—the earnings of capital.

Other things being equal, the larger the national dividend, the larger will be the share of the agents of production.

* Sir T. H. Penson in his *Economics of Everyday Life* following the prevailing English ideas on the subject makes the following remarks: "The old idea was that the whole annual produce of the industry of a country was distributed among the different classes of producers. A certain amount went to the landowners, a certain amount to the labourers, and the remainder to the capitalists. . . . To-day we approach the problem from the other end. The net product of a particular industry or of a particular productive effort is distributed as income among those who have taken part in it. The sum of such net products throughout the whole country would be the total amount that

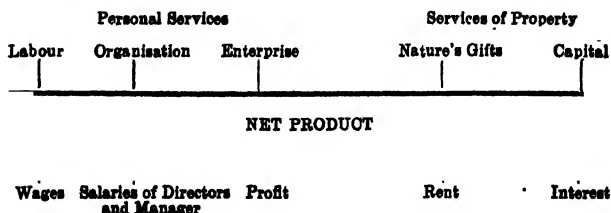
[The development of the idea of the National Dividend is in the main, due to Professor Marshall,—Marshall has made this concept one of the fundamental bases of the theory of Distribution; and it has been used to overthrow the Wages Fund theory and some protectionist fallacies.

Marshall emphasises the fact that the *National Dividend* is a *flow* and not a *fund*, it is a flowing income stream and not a fixed fund. The constant flow of new goods through supply which flow out again through demand and consumption is properly suggested by the word 'flow' or stream and not by the word 'fund'.]

could be distributed as income and hence would be the sum of all incomes. The total income of a particular class such as the wage-earners could only be found by adding together the incomes of all the individual members of that class. But it must be remembered that *the only actual distribution* that takes place is the division among the members of an industrial group of the results of their joint effort. *Distribution, in other words, is the determination of the income of individuals, and not of classes.* The method of distribution is practically as follows:—The business organiser may be regarded as the distributor. . . . Thus two facts are clear:—(1) the distribution is based on estimated product *i.e.*, on what the results of the effort are expected to be, (2) the incomes, according to the terms of the contracts are paid in instalments and are not affected by what the net product actually proves to be at the end of the year. For one service only was no contract made, viz., the service of enterprise.

The incomes which the business organiser has contracted to pay are the rewards of services. **SERVICES, LIKE COMMODITIES HAVE A MARKET PRICE**, and that market price is determined by the interaction of the forces of Demand and Supply.

The correspondence between service and income is shown in the following diagram.



. There is one other aspect of the individual income that should not be lost sight of, viz., that income is frequently derived from more than one source—is frequently a reward for more than one type of service."

Professor Pigou on the distinction between Marshall's conception of the National Dividend and Fisher's conception.

"For the dividend may be conceived in two sharply contrasted ways: as the flow of goods and services which is *produced* during the year, or as the flow which is *consumed* during the year. Dr. Marshall adopts the former of these alternative. He writes: "The labour and capital of the country, acting on its natural resources, produce annually a certain net aggregate of commodities, material and immaterial, including services of all kinds. This is the true net annual income or revenue of the country, or the national dividend" (Marshall, *Principles of Economics*, p. 524). Naturally since in every year plant and equipment wear out and decay, what is produced must mean what is produced on the whole when allowance has been made for this process of attrition. To make this clear, Dr. Marshall adds elsewhere: "If we look chiefly at the income of a country, we must allow for the depreciation of the sources from which it is derived."—Marshall, *Principles of Economics*, p. 80). In concrete terms, his conception of the dividend includes an inventory of all the new things that are made, accompanied, as a negative element, by an inventory of all the decay and demolition of old things. Professor Fisher on the other hand, placing in the forefront of his argument the proposition that savings are in no circumstances income, claims unequivocally to identify the national dividend with those services, and those only, that enter directly into consumption.

Dr. Marshall's definition of the *national dividend* is likely, on the whole, to prove more useful than the other, and I propose in what follows to adopt it"—A. C. Pigou, *The Economics of Welfare*, 1924, pages 34-35, 37.

Cannan's criticism of the National Dividend idea in distribution.

There is substance in Cannan's criticism.

"It may be well to ask whether it is desirable to maintain any longer the fiction of Distribution, that is, the assumption, for purposes of exposition, that all products are first thrown into a common heap or thrown into a common pool and subsequently divided among income-receivers.

I am inclined to answer the question in the negative. The assumption has always been applied to political countries, and this is very misleading. The union of Great Britain with Ireland, and the later separation of Southern Ireland from that union, the creation of Poland and Czecho-Slovakia into separate states must have considerably altered the percentages of the total incomes of their countries received by particular inhabitants without really altering their relative incomes. . . .

To improve upon the old idea of Distribution by making the whole-

world (or even the whole of the commercial part of the world, if that is any smaller) the unit instead of the political country is impracticable. It would make the assumption too cumbrous to be workable. . . .

I shall therefore discard Distribution and discuss the incomes of workers and of property-owners not as proportions of a common whole but as absolute amounts per head—Cannan, *A Review of Economic Theory*, 1929, pages 331-332.

General Theory of Distribution.

The national dividend is distributed among the agents of production as rent, profit, interest and wages ; and *with respect to each employed agent of production, the distribution is determined by demand and supply.*

"The uses of each agent of production are governed by the *general conditions of demand in relation to supply* ; that is, on the one hand by urgency of all uses to which the agent can be put, taken together with the means at the command of those who need it ; and on the other hand, by the available stocks of it."

We have to take into consideration *the demand side as well as the supply side* in connection with each agent ; and we must also note that the price paid for an agent has a reflex action upon its supply.

(a) First let us consider the *demand side*. The amount offered by an employer for a factor of production *depends* upon its *marginal productivity* (i.e., product of the final increment of that factor) to him.*

The marginal productivity of a factor thus represents the demand price for that factor.

Labourers of equal efficiency in a given employment will

* Employers to get the greatest profit for themselves will try to adopt the most economical combination of the factors of production ; and the most economical combination is that in which the marginal productivity of each factor equals its cost. In order to realize the maximum profit possible under the circumstances, each employer will endeavour to apportion his land, labour and capital so that the marginal product (the increment of product attributable to the marginal unit) of each factor of production will equal its expense to him. The amount offered by an employer for a factor of production will depend upon its marginal productivity to him.

receive the same rate of wages ; and the wages of each labourer will tend to equal the marginal product of labour.

If wages are above productivity, then the unwillingness of the enterprisers to hire workers will bring wages down. When wages are below marginal productivity, the competition between enterprisers to hire more labourers will raise wages up to marginal productivity. In this way wages tend to equal the marginal product.

Similarly the demand price of the enterpriser for capital tends to equal the marginal productivity of capital. And similarly as regards the demand price of land.

(b) Now let us consider the supply side. On the supply side the remuneration of each agent of production tends to equal its supply price. *(marginal cost or expenses)*

The remuneration of an employed factor will thus tend to equal its marginal productivity on one side and its supply price (when it has one) on the other.

So far as competition works freely, different enterprisers in the same market will pay the same rate of wages for the same kind of labour, the same rate of interest for the same kind of capital goods, and the same rent for the same kind of land.

[We have assumed that all labourers are of equal efficiency, etc.

As a matter of fact all labourers are not of equal efficiency And to complete the theory of normal distribution we have simply to add that factors in production which possess differential advantages in production tend to be paid in addition to the normal remuneration of factors of marginal efficiency, the full value of their differential advantages.]

This is the *explanation given by Marshall (and other economists of the same outlook) as to how the distribution of the national dividend among labour, capital, land and organization takes place broadly under the actual conditions of a modern country.*

How would distribution be determined in imaginary states under imaginary conditions? Here we have plenty of scope for curious intellectual problems but of little or no practical

importance. A very extreme case would be the working of distribution in the ideal state imagined by the honest lord Gonzalo.

"I the commonwealth I would by contraries
Execute all things ; for no kind of traffic
Would I admit ; no name of magistrate ;

No occupation ; all men idle, all ;
And women too."—(*The Tempest*, II. i.)

Distribution under imaginary and actual conditions.

An extreme case as imagined by the Lord Gonzalo in Shakespeare's *Tempest* is mentioned in page 295.

Suppose again that in an imaginary country every man produces all things and services that he wants. He produces his own income unaided and he consumes it. There is no question of distribution.

Only when men are engaged in combined effort for producing wealth, then there is the question of distribution.

Suppose again in an imaginary country, all men have equal skill in all industries. Suppose they have equal amounts of capital. Suppose there is perfect mobility of labour and capital as between all industries. Suppose every one has as much of land or other free gifts of nature as he requires. And work is so simple that no class of expert business organisers is required. Then the incomes of all persons in that country will be equal.

In an actual capitalist and competitive country, like Germany or Britain or the U. S. A., all labourers have not equal skill, they have not equal capitals, there is not perfect mobility of capital and labour as between industries and a separate class of expert business organisers exists. So we have the problem of distribution under actual conditions in such capitalist and competitive countries. In actual capitalist and competitive countries the supply of able business organizers is small, the supply of labour is large—and the profit earned by able business organizers is high, the wages of labour much lower. Suppose under imaginary conditions the supply of able business organisers becomes much greater than the supply of labour. The larger supply of business ability will increase efficiency of wealth production in the country, will increase national income; with larger supply of business ability the rate of remuneration for business ability will fall, and with reduced supply of labour, the rate of remuneration for labour will rise—and business

men will have lower incomes than labourers. Under these imaginary conditions of supply of business ability and labour, profits are low, wages high. Under actual conditions of supply of business ability and labour in modern capitalist countries wages are low, profits high.

In Socialist Russia, industry is state-owned and state-managed and so the State determines distribution and fixes the incomes of all persons employed in state-owned and state-managed industries. In capitalist and competitive countries the private employers play an important part in determining the distribution of the national income among labourers, capitalists and owners of natural agents.

Actual distribution in modern countries and the world factor.

The nations of the world are now closely knit together economically and in other respects. In any modern country production, monetary and banking conditions are much dependent on the world factor—upon conditions in other countries of the world. The same is also true to some extent of distribution in any modern country.

Civil war in China, boycott movement in India, and some development of cotton manufacturing industry there may reduce much the demand for English cotton manufactures and bring about reduction of wages in the cotton industry. The world economic depression by reducing much the demand for agricultural and manufactured exports of countries with large export trade, has much reduced wages and profits in the exporting industries of such countries.

The world factor in its influence on actual distribution in modern countries should and is likely to get an increasing share of the attention of the economists and statesmen of the world.

How far is it true to say that the Theory of Wages is an application of the General Theory of Value. (C. U. 1931).

Wages = value of the services of labour.

The labourer is paid the value of the services of his labour in the form of wages.

Wages or the value of the services of labour is *broadly* determined in the same way as the value of any other service or commodity. It is determined by the equilibrium of demand and supply. *Broadly wages is thus a particular case of the general theory of value*, it is an application of the general theory of value.

Wages depending upon the equilibrium of the demand for the services of labour and the supply of such services, the theory of wages must consider fully the peculiarities of such demand and supply as

regards the services of labour. These peculiarities of demand and supply will make the theory of wages to that extent different from the theory of rent or the theory of interest or the theory of profit, or the theory as regards the value of a commodity. Refer to these peculiarities on pages

Some remarks on the theory of normal distribution.

The following remarks of Prof. Chapman in his *Outlines of Economics* are of interest.

(a) Chapman remarks that the theory of the payment made for any one agent of production is *in essentials* identical with the theory of payment made for any other agent of production—that is to say, to take one example, the theory of interest paid for capital is in essentials identical with the theory of wages paid for labour. Chapman implies that this is so because the remuneration of each agent of production tends to equal the marginal productivity of that agent on one side and its supply price on the other.

[It should be remembered, however, that the qualification “*in essentials*” is an important one. Individual characteristics stand out in each theory, because capital and labour are different in nature, though they have striking resemblances to one another in that both are agents or factors of production.]

(b) *This beautiful and symmetrical theory of normal distribution* as expounded by economists is *not literally true*. The generalisations of this theory hold *true only of tendencies*; and these tendencies are interfered with in the actual business world by obstacles and economic friction of various kinds. [For example, the proportions in which the factors of production are actually combined by different enterprisers are not always adjusted with the nicety and skill which the theory seems to imply.]

[*A study of the normal theory of distribution is helpful however and useful in this way*. It enables us to understand the tendencies and with the understanding of those tendencies we are making a beginning though only a beginning of an understanding of the social system of distribution.]

*** The marginal productivity theory of distribution—a criticism.**

(A) The marginal productivity theory does not furnish a complete ethical justification of the present economic order.

Does the marginal productivity theory of distribution furnish any complete moral justification of the present economic order? The answer

* The marginal productivity theory of distribution is best stated in the words of Prof. Alfred Marshall, the highly respected leader of the English marginal school.

Net product.

"Every business man indeed is constantly endeavouring to obtain a notion of the relative efficiency of every agent of production that he employs; as well as of others that might possibly be substituted for some of them. He estimates as best he can how much net product will be caused by a certain extra use of any one agent. By net product is meant net addition to the total value of his product, after deducting for any extra expenses that may be indirectly caused by the change, and adding for any incidental savings. He endeavours to employ each agent up to that margin at which its net product would no longer exceed the price he would have to pay for it.

Provisional conclusion.

To sum up the whole in a comprehensive, if difficult statement:—Every agent of production, land, machinery, skilled labour, unskilled labour, etc., tends to be applied in production as far as it profitably can be. If employers, and other business men, think that they can get a better result by using a little more of any agent they will do so. In this they do on a large scale just what we have seen the housewife doing on a small scale: they estimate the net product (that is the net increase of their total output after allowing for incidental expenses) that will be got by a little more outlay in this direction, or a little more outlay in that; and if they can gain by shifting a little of their outlay from one direction to another, they do so. (Marshall—*Economics of Industry*, Book iv. Chapter I).

"In the last chapter we confined our attention to the manner in which the national income is distributed among the various agents of production, in accordance with the quantity of each agent, and the services which it renders. We have now to consider the other side of the problem, viz., the influence which the remuneration of each agent exerts on the supply of that agent. . . .

Two-fold influence of demand and supply on wages.

Thus again we see that demand and supply exert equally important influences on wages; neither has a claim to predominance; any more than has either blade of a pair of scissors, or either pier of an arch. Wages tend to equal the net product of labour; its marginal productivity rules the demand price for it; and, on the other side, wages tend to retain a close through indirect relation with the cost of rearing, training and sustaining the energy of efficient labour. Thus the supply-price and the demand-price of labour tend to be equal: wages are not

is no. *The marginal productivity theory simply describes how the wealth that is produced under present conditions is actually distributed. But it does not prove that the present distribution is just, that present distribution is as it should be.*

governed by demand-price nor by supply-price, but by the whole set of causes which govern demand and supply.

Interest governed by the forces of supply and demand.

Thus then interest, being the price paid for the use of capital in any market, tends towards such a level that the aggregate demand for capital in the market, at that rate of interest, is equal to the aggregate stock forthcoming there at that rate.

Land is on a different footing from the other agents of production.

. For while the supplies of all other agents of production respond in various degrees and various ways to the demand for their services, land makes no such response.

The earnings of the several agents of production, according to their marginal services, exhaust the national dividend.

To conclude this stage of our argument:—The net aggregate of all the commodities produced is itself the true source from which flow the demand-prices for all the commodities, and therefore for the agents of production used in making them. Or, to put the same thing in another way, *this national dividend is at once the aggregate net product of, and the sole source of payment for, all the agents of production within the country*: it is divided up into earnings of labour; interest of capital; and lastly the producer's surplus, or rent, of land. It constitutes the whole of them, and the whole of it is distributed among them; and the larger it is, the larger, other things being equal, will be the share of each of them. It is distributed among them, speaking generally, in proportion to the need which people have for their several services—i.e., not the *total* need, but the *marginal* need. By this is meant the need at that point, at which people are indifferent whether they purchase a little more of the services (or the fruits of the services) of one agent, or devote further resources to purchasing the services (or the fruits of the services) of other agents." (Marshall—*Economics of Industry*, Book vi. Chapter II).

Some criticisms of the marginal productivity theory of distribution.

As Maurice Dobb puts it—"As a general theory of distribution the theory of marginal productivity tells one that, given a certain relation between the supply of various factors of production, the total value produced must be shared in a particular way. If one can assume the supply of the various factors as "constants," the theory is, therefore, adequate. But in practice one cannot make this assumption, and the theory tells one nothing about the way that variations in these factors are themselves related, which is the fundamental issue.—Maurice Dobb, *Wages*, 1928, p. 84.

The marginal productivity theory of distribution is severely criticised in his *Work and Wealth* by Mr. J. A. Hobson.

"The 'law of distribution' which emerges is that every owner of

This will appear from the following considerations :

(1) Under present conditions distribution is according to productivity. *Whether distribution according to productivity is just—this has been disputed.* Many socialists maintain that distribution according to needs is a higher moral ideal. (Some socialists e.g., George Bernard Shaw would regard equal distribution as a better ideal than marginal productivity distribution).

any factor of production 'tends to receive as remuneration' exactly what it is 'worth'. Now this 'law' is doubly defective. Its first defect arises from the fact that economic science assigns no other meaning to the 'worth' or 'value' of anything than what it actually gets in the market. To say, therefore, that anybody 'gets what he is worth' is merely an identical proposition and conveys no knowledge. The second defect is the reliance upon a 'tendency' which falsely represents the normal facts and forces. It is false in three respects. It assumes in the first place an infinite divisibility of the several factors, necessary to secure the accurate balance of 'preferences' at the margins. It next assumes perfect mobility or freedom of access for all capital and labour into all avenues of employment. Finally, it assumes a statical condition of industry, so that the adjustment of the factors on a basis of equal productivity and equal remuneration at the margins may remain undisturbed. *All three assumptions are unwarranted.* Very few sorts of real capital or labour approach the ideal of infinite divisibility which marginalism requires. An individual worker, sometimes a group, is usually the minimal 'drop' of labour, and capital is only infinitely divisible when it is expressed in terms of money, instead of plants, machines or other concrete units. Still less is the case that capital or labour flows or 'tends' to flow with perfect accuracy and liberty of movement into every channel of employment where it is required, so as to afford equality of remuneration at the several margins. Lastly, in most industrial societies the constant changes taking place, in volume and in methods of industry, entail a corresponding diversity in the productivity and the remuneration of the capital and labour employed in the various industries 'at the margin.'

Marshall on the relation of Capital and Labour in general.

In the short run, the relation between capital and labour is one of competition; in the long run, the relation between capital and labour is one of co-operation.

An employer-capitalist, employing a number of labourers in his mine or his factory, may, by reducing wages, increase his profit in the short run. Economic conditions in that industry and also in the country generally may be such as to compel the labourers to accept reduced wages for the time being, more remunerative employment being not available for them. Again there is competition between capital and labour as regards employment, the increasing use of capital and machinery in an industry often leading to the displacement of

(2) *On the ethical side of distribution, we are concerned not so much with the income of a factor in production but with the incomes of persons.* The productivity theory explains how the rent of an acre of land tends to equal the value of its surplus produce. But this does not satisfy us that the landlord who gets that rent is justified in taking it.

(3) Again the efficiency of the labourer which is one of the things determining his productivity often depends largely upon the opportunities which he can get and his opportunities depend upon the social environment—the low efficiency of a labourer which will give him low earnings is not wholly due to the workman himself but may be partly due to society. And society should take steps to increase his efficiency

labourers. A new machine with much capital invested may be able to do as much work as old machinery with little capital invested and employing many labourers. But in the long run growth of capital and machinery opens new and valuable fields of employment for labour in many industries often compensating for the displacement of labour by capital in some industries.

Marshall thus discusses the relations of capital and labour in general:

"It is obvious that though capital in general is constantly competing with labour for the field of employment in particular trades; yet since capital itself is the embodiment of labour as well as of waiting, the competition is really between some kinds of labour aided by a good deal of waiting, and other kinds of labour aided by less waiting. On the one side, for instance, are many who make shoes by hand, and a very few who make awls and other simple implements, aided by a little waiting; on the other are a relatively small number who work powerful sewing-machines which were made by engineers, aided by a good deal of waiting. There is a real and effective competition between labour in general and waiting in general. But it covers a small part of the whole field, and is of small importance relatively to the benefits, which labour derives from obtaining cheaply the aid of capital, and therefore of efficient methods in the production of things that it needs.

For speaking generally, an increase in the power and the willingness to save will cause the services of waiting to be pushed constantly further; and will prevent it from obtaining employment at as high a rate of interest as before. That is, the rate of interest will constantly fall, unless indeed invention opens new advantageous uses of round-about methods of production. But *this growth of capital will increase the national dividend; open out new and rich fields for the employment of labour in other directions; and will thus more than compensate for the partial displacement of the services of labour by those of waiting.*

..... Finally capital in general and labour in general co-operate in the production of the national dividend, and draw from it their earnings in the measure of their respective (marginal) efficiencies. Their mutual dependence is of the closest; capital without labour is dead; the labourer without the aid of his own or someone else's capital would not long be alive. Where labour is energetic, capital reaps a high reward and grows apace; and, thanks to capital and knowledge,

by providing him with ampler opportunities. *Present distribution is not just and is capable of much improvement by proper social provision of better opportunities for the poorer classes.*

(4) *The theory is only a statement of a normal tendency.* The theory states that the labourer tends to get wages equal to the marginal product of labour, the capitalist tends to get interest equal to the marginal product of capital etc.

Actual wages however may differ from normal wages measured by marginal product, the difference being due to custom, and other forms of economic friction, deliberate action and efforts on the part of different classes etc. So even if we accept that marginal productivity is a proper ethical standard, even if we take the view that the wages of labour should equal the marginal productivity of labour, even then present distribution is not ethically justified.

For some arguments advanced in justification of the present system of distribution, and showing that it has a sort of rough justice about it, (though not completely justified from the ethical standpoint), see Chapter on Socialism, etc. page

(B) The marginal productivity theory of distribution does not correctly represent actual economic conditions.

Mr. J. A. Hobson in his *Work and Wealth* holds that the marginal productivity theory of distribution relies upon a "tendency" which *falsely represents the normal economic facts and forces. ...Refer to pages 299-300, footnote.*

Summary.

'The National Dividend is distributed among the different factors of production viz., land, labour, capital and organizing.' The remuneration of each factor is determined by its demand and supply, it tends to equal (1) the marginal productivity of the factor on the side of demand and (2) the supply price on the side of supply. Wages and also interest and profit can be explained in this way. Land has no supply price.

The marginal productivity theory of distribution explains only how the National Dividend is distributed; it does not prove that the present

the ordinary labourer in the western world is in many respects better fed, clothed and even housed than were princes in earlier times. The co-operation of capital and labour is as essential as that of the spinner of yarn and the weaver of cloth: there is a little priority on the part of the spinner; but that gives him no pre-eminence. *The prosperity of each is bound up with the strength and activity of the other; though each may gain temporarily, if not permanently, a somewhat larger share of the national dividend at the expense of the other.*"—Marshall, *Economics of Industry*, Book V., Chapter II, pp. 257-58.

system of distribution according to marginal productivity is perfectly just and completely justified from the ethical standpoint.

Questions.

1. What is the National Dividend? Sketch briefly the general theory of distribution explaining how the National Dividend is divided among the different agents of production.

2. "The theory of payment made for any one agent in production is essentially identical with the theory of payment made for any other agent in production." Explain and discuss this statement. (C. U. 1913).

(a) What is meant by saying that wages tend to equal the marginal product of labour? Can you explain interest and profit in a similar way?

(b) Does such an explanation furnish any complete ethical justification of the present economic order? (C. U. 1913).

4. To what extent is it desirable and practicable to modify the distribution of the national dividend in a modern industrial community by conscious social action? (C. U. Hon. 1931).

Marshall, Taussig, and other leading economists on the whole support the existing distribution in capitalist and competitive countries (a) as securing a sort of rough justice making payment depend on service and (b) as promoting national production of wealth. But they are opposed to the existing large inequalities of income and wealth.

In this they have the support of public opinion and the tendency of legislation in these capitalist and competitive countries.

It is *desirable* to remedy the large existing inequalities in income and wealth. Also it is *practicable*—in fact it is being done in all progressive modern states (e.g., Britain, U. S. A., Germany, etc.) by conscious social action and to an important extent by legislation.

Many modern states have (i) minimum wages legislation preventing the payment of wages below a certain level, (ii) legal regulation of interest specially as regards loans for consumption, (iii) progressive taxation of income and wealth taking much from the rich and giving substantial aid to the poor by social services expenditure on education, sanitation and also through old age pensions, and insurance schemes and other things.

CHAPTER II.

Rent.

Rent.

The term "rent" is used to mean the following things :

(1) It is used generally by economists to mean *the income from land and from other free gifts of nature*. Rent in this sense includes rent from agricultural lands, rent of building sites, rent of mines, rent of pastures, rent of water privileges etc.

As the chief thing that is usually rented is land, *rent is often made synonymous with the income from land alone*.

(2) The term "rent" is sometimes used to refer to *a periodic payment for the use of land together with any capital invested in it or on it*.

Thus the income derived by a house-owner from land and capital invested on land in the shape of a building is called in common usage *rent*. Similarly the *rent* of a farm in English popular usage means the income from the farm land and also the capital invested on the land and in it in the form of buildings, roads, hedges, gates, drainage etc.

(3) Rent is also used to refer to *the payment for any differential advantage in production enjoyed by any agent in production (land, labour, capital or organization)*.

This is the widest sense of the word *rent* and it includes rent in (1) which is the payment for a differential advantage in natural agents only.

A differential advantage means a property or quality possessed by any agent in production, which causes it to have a greater economic value than the least valuable agent or factor in the same class, which is nevertheless just valuable enough to be employed.

Factors or agents of marginal capacity are to be distinguished from factors of super-marginal capacity. Land which

is just good enough to be cultivated and which would not be cultivated if it were a little worse than it is, is an agent of marginal capacity ; and land which is better than this land of marginal capacity is a factor of super-marginal capacity)

[*Rent on superior land is paid for the differential advantage*, possessed by it as compared with inferior land just valuable enough to be cultivated. A labourer in a cotton mill, who is just able enough to be engaged as a worker in the mill, is of marginal capacity and a more efficient labourer is a factor of super-marginal capacity and the extra wages which he gets over and above the wages got by the labourer of marginal capacity can be looked upon as a rent element in wages. Similarly there is a rent element in the total profits of the employer of super-marginal capacity due to the differential advantage enjoyed by him in production.]

Rent of land.

Land being the chief thing for which a rent is paid, we take up land rent first.

The theory of land rent has an interesting history ; and we shall notice the views of Ricardo before giving the modern re-statement of the theory of rent.

(1) * The Ricardian Theory of Rent.

(Ricardo, one of the greatest English economists of the classical school, developed a theory of land rent, which in essentials may be regarded as the basis of the modern theory of rent. His theory is briefly this :

* The following extracts from Ricardo will make clear his position "Rent is that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil. . . . On the first settling of a country in which there is an abundance of rich and fertile land, a very small proportion of which is required to be cultivated for the support of the actual population or indeed can be cultivated with the capital which the population can command, there will be no rent for no one would pay for the use of land when there was an abundant quantity not yet appropriated, and, therefore at the disposal of whosoever might choose to cultivate it . . . when with the progress of society land of the second degree of fertility is taken into cultivation, rent immediately commences on that of the first degree."

(*Rent, according to Ricardo, is "that portion of the produce of the earth, which is paid to the landlord for the original and indestructible powers of the soil."*)

Ricardo regards *rent correctly as a differential return*, (and not a monopoly return) ; and he has some understanding of the *operation of diminishing returns*. Earlier English economists had some glimmerings of these two notions, but he is the first writer to bring these things into relation with his economic theory as a whole.

(*The land margin is made the central point in the Ricardian theory of rent*) In Ricardo's law of rent we have two margins (1) resort to inferior lands leading to an extensive margin (2) the law of diminishing returns leading to an intensive margin.

(All plots of land in a country are not equally fertile, they are not of the same quality ; some lands are of the first quality, some of the second quality, some of the third quality and so on.)

(a) *What is the historical order of cultivation in a country?*
(According to Ricardo, the most fertile land is cultivated first.)

(b) So long as the population of the country remains small, the needs of the population can be met by cultivating only a portion of the most fertile land in the country. And so

and the amount of that rent will depend on the difference in the quality of these two portions of land. When land of the third quality is taken into cultivation, rent immediately commences on the second and it is regulated as before by the difference in productive powers. At the same time the rent of the first quality will rise. . . . In such case capital will be preferably employed on the old land and will equally create a rent; for rent is always the difference between the produce obtained by the employment of two equal quantities of capital and labour. . . . The most fertile and most favourably situated land will be first cultivated. . . .

The exchangeable value of all commodities whether they be manufactured or the produce of the mines or the produce of land, is always regulated . . . by those who continue to produce them under the most unfavourable circumstances . . . *corn is not high because a rent is paid but a rent is paid because corn is high.* Rent is not a component part of the price of commodities.

. . . . The rise of rent is always the effect of the increasing wealth of the country, and of the difficulty of providing food for its augmented population, it is a symptom, but it is never a cause of wealth
(Ricardo—*Principles*, Chapter II).

long as the best land is abundant and every one can have it merely by taking possession, it is obvious there can be no such thing as rent. No rent is paid at this stage.

(c) As the population grows, the needs of the people become greater, a larger amount of agricultural produce is required, and so more land has to be cultivated. If there is a considerable increase in the population, then the whole of the first quality land will be cultivated and also a part of the second quality land. (This resort to the inferior soil is due to the operation of diminishing returns—if there were no diminishing returns then all the produce required by the population would have been raised from the first quality land by the application of suitable doses of labour and capital.)

The first quality land thus bears a rent; and the amount of rent is equal to the difference between the value of its produce, and the produce of the second quality with the same expenditure of labour and capital.

The land of the second quality is now said to be land on the margin of cultivation. Land on the margin just pays for the expenses of cultivation, viz., wages and profit on capital, and it yields no surplus for rent. Land of a superior grade with the same expenditure of labour and capital, pays the same rates of wages and of profit, and in addition leaves a surplus for rent.

In course of time with a greater growth of population, it becomes necessary to cultivate land of still poorer quality, viz., land of the third quality. And then land of the second quality will bear a rent equal to the difference between the value of its produce, and that of land of the third quality. Land of the first quality will now pay a higher rent equal to the difference in value between the produce of the first quality and the produce of the third quality.

When the third quality of land also has to be brought under cultivation, the margin of cultivation is said to descend, and the third quality is now on the margin of cultivation.

With every fall in the margin of cultivation, rent increases.

(d) Ricardo notices that rent is due to differences in fertility, and also to differences in situation. Of two lands equally

fertile, one which is more favourably situated, (which is nearer to the market and can send its produce to the market at a cheaper cost), will have the higher rent.

(e) *Price of produce.*

The price of produce is determined by the cost of production on the margin of cultivation. The land on the margin pays no rent, so rent is not an element in the cost of production on the margin of cultivation, and so rent is not an element of the price of agricultural produce.

The price of produce is thus not affected by the rent paid on superior land.

* **Criticisms and objections against the Ricardian Theory.**

(1) Ricardo maintains that rent is paid for the indestructible properties of the soil; to this some critics have objected that *the properties of the soil are not indestructible and that its fertility is often exhausted* and it may be also created by fertilisation. [The objection of the critics of Ricardo would be valid if by soil we refer only to the top layer of the land that contains certain elements necessary to plant life; but there are other qualities of the land that are practically indestructible and unproduceable, e.g., the climate, extent (standing room) and the conformation of the land].

The four main criticisms of the Ricardian Theory are given below.

(2) Mr. Carey, an American economist, has attacked the Ricardian theory on the ground that it is historically false.

* As Sidgwick (*Principles*, Book II) points out, three theories are included in what is commonly known as Ricardo's doctrine of Rent—(1) Historical theory as to the origin of Rent (2) Statical Theory of the actual determination of Rent (3) Dynamical Theory of the causes which continually tend to increase Rent. A full criticism of the Ricardian doctrine must examine each of these three theories.

In the words of Prof. Seligman "The traditional law of rent includes three statements: rent is the result of the law of diminishing returns; rent is a differential or surplus over marginal or no-rent land; rent is not a part of cost of production." And from this he goes to a proposition—which all will not accept "so far as these statements are true, however, they are not peculiar to land rent."

Ricardo says that in a country the most fertile land is cultivated first and then the second quality of land and then even less fertile land and so on. Carey says that experience in America shows that the less fertile, high and thin, dry soils yielding a small return and requiring little clearing and draining are cultivated first and it is only later on that the lower and richer and more fertile lands (requiring large expenditure for clearing and draining) are cultivated.

[Carey criticised and Ricardo defended].

Carey's objections, on closer examination, lose their force.

(a) As against Carey, Walker points out that the order of cultivation is not invariably from less fertile lands to more fertile lands even in new countries like America.

(b) Ricardo's historical order of cultivation is not an essential part of his theory of rent. And even if we have to reject his order of cultivation, his theory in its essentials will hold true.

(c) And it is further pointed out that Ricardo's order of cultivation is not historically incorrect when properly understood.

Ricardo uses the expression 'productive land' which Carey takes to mean fertile land in the limited sense ; if the expression 'productive land' is used to include all advantages, *viz.*, fertility relative to place and time, convenience of situation etc., then Ricardo's historical order of cultivation from more productive to less productive lands is historically correct. Moreover Ricardo speaks plainly that the *most fertile and most favourably situated land will be first cultivated* (see page 306 footnote).

(3) Ricardo assumes equal intensity of cultivation for superior as well as inferior lands. In actual fact we find that the best land is always more intensively cultivated when an inferior quality of land comes into cultivation.

(4) *The Ricardian theory of rent does not apply to actual rents in the different countries of the world.* It assumes full and free competition between landlord and tenant, landlord and tenant each unflinchingly seeking and unfailingly finding his best market.

As a matter of fact, however, actual rents are determined not simply by competition but are also influenced by custom, public opinion, the sentiment of the landowning class, legislation, etc.

(To this objection it may be answered that the Ricardian theory of rent like other economic laws is true only under certain hypothetical conditions, the conditions assumed in this case being the full and free competition between landlords and tenants).

(5) *Rent and price.*

Ricardo says rent does not enter into price, it does not form part of the price of agricultural produce. Some critics (Cairnes, etc.) point out that rent in certain cases does enter into price; in Australia monopoly rents have increased price. Such monopoly rents are however exceptional cases and the Ricardian law does not apply to them.

Ricardo's proposition that 'rent does not enter into price' does not also apply to rent paid for land marginal for one use but still paying rent because it bears a rent for some other use.

(6) Menger, one of the leaders of the Austrian school, rejects the Ricardian theory on the following grounds:

"If all lands are equally fertile and occupy equally favourable situation then according to Ricardo's theory no land could yield any rent since the inequalities of which we are speaking would not exist."

In answer to this objection of Menger, the following points are to be noted:

(a) All lands are not equally fertile or equally well-situated, different grades of lands have to be cultivated and so the Ricardian theory applies. Menger speaks only of hypothetical cases which are not to be found in the actual state of things.

(b) Even if all lands are equally fertile and equally well-situated, if the demand for agricultural produce is such that all lands have to be cultivated intensively then there will be an intensive margin and rent.

(2) A re-statement of the Theory of Rent.*

The modern theory of rent is based largely upon the work of Ricardo. An examination of Ricardo's theory has shown that it has to be modified in certain particulars before it can be accepted as valid.

The best land is cultivated first: In considering which is the best land, we must take into account considerations of *locality* (i.e., advantages of situation etc.) as well as of *fertility*. And the best land known in view of existing knowledge and with reference to existing resources of capital and labour, when other things are equal, is the first to be worked.

The different plots of land in a country are divided into

* In connection with the theory of rent, we have to notice as regards land (1) the Scarcity Aspect (2) the Differential Aspect. In any civilised country the supply of land has a scarcity, it is fixed in supply. Also all plots of land in the country have not equal advantages in point of fertility and convenience of situation—some belong to the first class, some to the second class, still other plots to the third class, etc.

"The Scarcity Aspect. The fact that the supply of land is fixed has the following significance. If the demand for land increases, the price will tend to rise. This is also true for a short period at least, of an ordinary commodity. But in the latter case, there would ensue an increase in supply which would serve to check the rise in price, and possibly, if production on a larger scale led to improved methods of production bring the price down eventually below its original level. In the case of land, no such reaction is possible. . . . For most purposes, however, it is of more interest to compare land with other agents of production, especially with capital and labour, rather than with ordinary commodities. . . . An increase in population implies an increase in the supply of labour; and it is likely to be accompanied by an increase in the supply of capital; in other words, *the supply of these agents will expand, as the demand for them expands. But the supply of land will remain what it was.* . . .

The Differential Aspect . . . we do not expect to find that any variety of an ordinary commodity will be produced, which is so poor in quality as to be entirely valueless. But since it is nature which has produced the land, without any assistance or guidance from man, there are many pieces of land which are so unfertile, or otherwise so unsuitable for productive purposes, as to be quite valueless from the economic standpoint. . . . What then, is likely to be the value and rent of this marginal land, this land which is just on the "margin of cultivation"? Some readers may find the answer startling. The rent of the marginal land will be nil, because it will not pay to cultivate it, if any appreciable rent is charged.

What then will be rent of a fertile and well-situated farm . . . ? It is the pure economic rent, the rent which represents the full annual payment which it would be worth paying to obtain the use of the land alone, which will measure, as we have said, the differential advantage of the land in question over land on the margin of cultivation"—Henderson, *Supply and Demand*, Chap. vi.

Also refer to Marshall, *Principles of Economics*, Book V, Chapter ix, pages 422-424.

different grades according to differences in *fertility, situation* relative to the market etc.

As the demand for agricultural produce increases with the growth of population, *on account of the operation of the law of diminishing returns*, lower and lower grades of land are brought into cultivation. In other words *the extensive margin falls*.

And at the same time, the grades of land already in cultivation are more intensively cultivated, *i.e.*, with greater expenditure of labour and capital. In other words, *the intensive margin falls*.

When the second quality land is brought into cultivation, the first quality is more intensively cultivated. And so on. (Farmers cultivate different grades of land to such different degrees of intensity that their marginal returns are equal).

Capital and labour applied to land on the extensive margin (*i.e.*, the worst land in cultivation) only pay the expenses of cultivation (wages and profits) and yield no surplus for rent. The dose of capital and labour applied to rich land on the intensive margin also covers wages and profits and yields no surplus for rent.

The economic rent of a superior grade of land is the total surplus over cost, yielded by all the doses of labour and capital applied to it up to the dose on the intensive margin. (See page 151, Part I).

The classical doctrine of rent may be thus re-stated after Prof. Marshall :

(1) The amount of the produce raised and therefore the position of the margin of cultivation (the intensive as well as the extensive margin) are both governed by the general conditions of demand and supply. They are governed on the one hand by *demand*, that is, by the numbers of the population, the *intensity* of their need for produce, and their means of paying for it ; and on the other hand by *supply*, that is, by the extent and fertility of the available land and the numbers and resources of those ready to cultivate it.

Thus cost of production, eagerness of demand, margin of production, and the price of the produce mutually govern one another.

(2) The amount of the rent, is not a governing cause but is itself governed by the fertility of land, the price of the

The amount of rent. produce, and the position of the margin ; rent is the excess of that value of the total returns which capital and labour applied to land do obtain over those which they would have obtained under circumstances as unfavourable as those on the margin of cultivation.

The price of agricultural produce tends to conform to the *marginal expenses of production* (expenses on the margin of cultivation) ; and rent is not an element of this cost of production on the margin.

Diminishing Return and Rent.

Without diminishing return (i.e., with constant or increasing returns) the entire agricultural produce required by a community can be produced from a portion of the best land and inferior grades of land have not to be cultivated. And so long as the best land is abundant only a portion of it being required for cultivation, there will be *no rent paid even for the best land*.

(a) *Rent results from the operation of diminishing returns when there are different grades of land in cultivation.* This is what is to be found in every country. (b) *Rent would result from the operation of diminishing returns even if all land is of uniform quality.*

(a) The law of diminishing returns operates as regards production from land ; and *the operation of diminishing returns upon the best land compels farmers after a time to cultivate also inferior soils* instead of applying more capital and labour to the best land. When an inferior grade of land is cultivated, the superior grade of land will bear a rent on account of its superior productivity and convenience of situation.

(b) *Even if all land is of the same quality* the operation of diminishing returns will lead to an intensive margin where a dose of capital and labour applied produces enough produce just to cover the cost of the dose of capital and labour applied. The total surplus over cost from all the doses applied up to the dose on the margin gives the economic rent of the piece of land. (Rent is measured from the extensive and also from this intensive margin).

Rent of Agricultural Land.

The economic rent of agricultural land is due to differential advantages, relating to fertility as well as convenience of situation. "The inequalities of situation relatively to the best market are just as powerful causes of producer's surplus (Rent) as inequalities of absolute productiveness" (Marshall). Of two pieces of land, having equal fertility, that one will have the higher rent, which is more conveniently situated by being nearer to markets etc. and of two pieces of land, enjoying equal situational advantages, that one will have the greater rent which has the greater fertility. *So fertility as well as situation are to be considered.*

Rent of Mines.

The subject of mine rents is one of considerable complexity.

Some peculiarities about mine rents.

Prof. Marshall points out that agricultural land properly cultivated retains its fertility and continues to be a perennial source of agricultural produce but that a mine is not a perennial source of minerals. The stock of minerals in a mine however large is fixed, and is exhaustible. (a) *So the rent of a mine includes a compensation for the exhaustion of the minerals ; in this respect mine rents differ from agricultural rents.* (b) *Mine rents resemble agricultural and other true rents in an important respect.* In agricultural rents, as well as in mine rents, we find the operation of diminishing returns leading to an extensive as well as an intensive margin. We have the extensive

margin—there are marginal mines just paying wages and profit on capital and yielding no surplus for rent, and also there are superior grades of mines paying wages and profit on capital and yielding in addition a surplus for rent. We have also the intensive margin—the continued application of labour and capital even to a rich mine will result in diminishing returns owing to greater difficulties of sinking shafts and working at lower depths, and after a time the intensive margin is reached.

Two elements in mine rents.

The total payment (or gross rent) paid to the mine-owner for the use of the mine thus includes (a) a payment for the minerals removed (as a compensation for the exhaustion of the mine), (b) a rent proper which is paid for the differential advantages in production relating to facilities of working and convenience of situation. Of two mines which are worked with equal ease, that one will have the higher rent which is more conveniently situated as regards markets etc., and of two mines enjoying equal situational advantages, that one will have the higher rent which more easily worked.

(Prof. Taussig makes certain interesting remarks about the rent of mines. He points out (a) that mining calls for an irrecoverable and usually a very large investment (b) that it involves a high degree of risk and uncertainty.

In former times the risk was so great that perhaps the total outlays were not recompensed by the total net earnings; and the risk is now less than in former days but the need of large initial investment is greater.

Taussig is also unwilling to accept Marshall's view that even the poorest mine will yield something to the owner as recompense for the mineral removed).

Rent of building sites.

Situation is the factor of special importance in determining the rent of building sites.

As regards buildings for residential purposes, situational advantages consist in natural beauty, healthfulness and fashionableness of the quarters under consideration. As regards building sites for business purposes, whether the situation is good or bad depends upon the purpose for which the building is

wanted whether it is for retail trade or for wholesale trade, for a bank or for any other purposes.

Marshall points out that building land does give a diminishing return of convenience as increased capital is put upon it. "From this it results that the theory of ground rents is substantially the same as that of farm rents."

Different economic uses of land.

Land may be put to different economic uses—for pasture, for agriculture, for building purposes etc.

Generally the poorest lands are used as pasture, and richer lands are used in agriculture. Land which cannot be profitably cultivated for agriculture, is used as pasture—the land marginal for pasture purposes yields no rent, and the more valuable pastures pay rent. As we go upwards in the scale of fertility, and according to relative demands for animal and vegetable products—land is used for agriculture, land marginal for agriculture pays no rent, and superior grades of land pay rent for the agricultural use (but land which is marginal for agricultural uses may be above the margin as pasture, and so it may pay rent as pasture). Again agricultural land, adapted to market-gardening near towns, has a higher value and pays a higher rent than land producing ordinary crops. Generally speaking, land for agricultural uses pays higher rent than land for pasture, and land for building sites in towns pays higher rent than land for agriculture.

Personal rent.

Personal rents closely resemble fertility rents.

All employers are not of equal efficiency—one employer can get more value out of his factors of production than another and can manage a bigger business. If the second employer is the marginal employer then the extra earnings of the first employer may be regarded as a personal rent due to his superior efficiency.

Then as regards professional men. There is the lawyer of marginal capacity, and also the lawyer of supermarginal capacity. The extra earnings of the lawyer of supermarginal capacity may be regarded as his *personal rent*.

So also as regards the wages of workmen. There is the carpenter of marginal capacity, just good enough to find employment. A carpenter of supermarginal capacity will earn higher wages than a carpenter of

marginal capacity. The extra wages earned by the carpenter of super-marginal capacity, due to his superior efficiency, may be regarded as the personal rent of the superior carpenter.

There is thus a rent element in profit, a rent element in professional earnings, and a rent element in the wages of workmen; and this personal rent is the payment for a differential advantage possessed by that person in the work of production.

Rent and the Price of Agricultural Produce.

Is rent an element of the price of agricultural produce? Does the rent paid on superior grades of land affect the price of produce in a country? Is high rent the cause of high price of agricultural produce?

If the quality of the agricultural produce is the same, the price of produce is the same in the same market whether it has been produced by superior or inferior land. In a country the most fertile land produces an equal amount of produce at less cost (of labour etc.) than land of inferior quality.

The price of agricultural produce in a country will equal the marginal expenses of production (i.e., the cost of production of the most expensive portion of the normal supply, that portion which is produced at the greatest disadvantage); otherwise this portion of the supply will not be produced, and so the total supply of agricultural produce will fall short of the total demand. Now rent is not paid on the poorest land in cultivation (land on the extensive margin), and there is also no rent on the intensive margin of superior land for the marginal dose produces just enough to cover only the cost of that dose and leaves no surplus for rent; so rent is not an element of the marginal expenses of production either on the extensive margin or on the intensive margin. The price of agricultural produce in a country is determined by these marginal expenses. So rent is not an element of the price of agricultural produce which is determined by these marginal expenses. High rent is not the cause of high price of agricultural produce.

[The increasing demand for produce leads to high price of produce and this high price of produce makes profitable the cultivation of even low grades of land and also the intensive

cultivation of superior grades of land, and thus leads to payment of high rent for the superior grades of land. *High rent is thus the effect of high price, and not its cause.*]

Will the remission of rent affect Price?

No. If the landlords remit rent upon the superior grades of land, then these rents will be appropriated by the tenants of the landlords. The price of agricultural produce will not be affected. The demand for agricultural produce will remain the same, the margin of cultivation will remain unaltered, and so also the marginal expenses of production, and so the price of agricultural produce will remain unaltered.

✓ When does rent enter into price?

We have seen that rent does not enter into the price of produce because rent is not an element of the marginal expenses of production.

In those exceptional cases where rent is an element of the marginal expenses of production, rent will enter into the price of produce.

(a) If the state has a monopoly of land in a country, and if it exacts a rent even for the use of the marginal land (the poorest land in cultivation), then this rent will enter into the price of agricultural produce.

In large portions of India, the state is the monopoly landlord and it charges a monopoly rent even for marginal land; and this monopoly rent entering into marginal expenses of production influences the price of agricultural produce.

(b) When rent has to be paid even on marginal land for one use (e.g. agriculture) to withdraw it from another use (e.g. pasture), then this rent paid for marginal land will enter into the price of agricultural produce.

Rent and the price of land.

We have seen that *the value of the produce of land determines rent; and rent in its turn determines the value of land.*

High price of agricultural produce leads to high rent; and high rent will bring about a high value of the land.

Suppose one piece of land has got such differential advantages over land on the margin that it bears a rent £10 per annum.

If the current rate of interest is 10% per annum, this piece of land with an annual rent of £10 will be regarded by owners and other persons as equal to capital of the value of £100. If

the current rate of interest is 5% per annum then the value of that piece of land will be £200.

A country where the supply of capital is large and the current rate of interest is low, where there is perfect security of life and property, and where great social prestige is associated with land-ownership, the price of a piece of land will be many times its annual rent. Where these conditions are less favourable the price of land will be lower.

Ricardian rent and actual conditions governing rent in different countries.

How far is the Ricardian doctrine of rent applicable to actual conditions in different countries?

The Ricardian doctrine of rent is true only hypothetically *i.e.* it is true upon the assumption that the land-owner as well as the tenant, each understands fully his own economic interests and that there is full and free competition and that the landlord or the tenant is not influenced in any way by other forces like custom, public opinion, sympathy for the tenant etc.

Now let us examine actual conditions in different countries.

(1) *The United States, Canada, Australia etc.:*

In these countries we have the nearest approximation to the hypothetical conditions assumed in the Ricardian law of rent.

In these countries, the tenant and the landlord are substantially on an equality as to intelligence, enterprise and mobility. Each understands his own interest fully, competition is full and free between them. And the *rent as determined almost exclusively by competition between landlord and tenant is the nearest approximation to economic rent (i.e. rent according to the Ricardian theory).*

(2) *England.*

In England Ricardo's law furnishes the great underlying principle according to which rents are primarily determined with more or less divergences from local or individual causes. Actual rent in England is primarily determined by competition between landlords and tenants; but the landlords are prevented from exacting the whole economic rent by public opinion and also by their class sentiment.

The tenants are regarded as being not on an equality with the landlords, they are looked upon more or less as dependent on the landlords. Public opinion demands that the landlords should not be very strict in their demands for rent and this is also the sentiment of the land-owning classes themselves; and so the *land-owners in England exact less than the full Ricardian or economic rent from the tenants.*

(3) *Continental Europe, India.*

In Switzerland, France, Italy and also in India rents were formerly fixed almost universally not by competition (as it is assumed in Ricardo's law) but by custom.

At present in India, rent depends upon three factors—custom, competition and legislation. The rent law of India starts from a basis of custom, accepts the legitimate influence of competition and seeks by legislation to restrain competition between landlords and tenants within reasonable limits. Rents in India are rising with the rise in the price of agricultural produce and increasing competition; but an excessive increase of rent is prevented by the rent law of the country.

"Custom is still to a large extent, the foundation of Indian rents, and the presumptions of unfettered competition which pervade the standard economic conceptions of rent (i.e. Ricardian rent) can only be applied with large reservations to existing conditions in India."†

(4) *Ireland.*

We have seen that in England and also in continental Europe the actual rent received by the landlords is lower than the full economic rent. The action of competition is moderated in favour of the tenants by public opinion and class sentiment in England and by custom in continental Europe.

In Ireland the actual rents paid by the tenants to landlords some-time ago were in excess of the full economic rent (the economic maximum).

The excessive competition for land between the tenants, sanguine, improvident and extremely prolific, led them to offer rents in excess of the economic maximum; and the absenteeism of the landlords and collection of rent through heartless agents and middlemen aggravated the situation.

Quasi-rents.

Certain kinds of income analogous to rent are called quasi-rents.

Prof. Marshall thus defines quasi-rent: "The net incomes from appliances for production already made may be called their quasi-rents; partly because we shall find that when we are considering periods of time too short to enable the supply of such appliances to respond to a change in the demand for them, the stock (of these appliances) has to be regarded as temporarily

† *Imperial Gazetteer of India*, Vol. III.

fixed. For the time they hold nearly the same relation to the price of the things which they take part in producing, as is held by land or any other free gift of nature, of which the stock is *permanently* fixed: and whose net income is a true rent."

Appliances for production include machinery, factories and other buildings, also business ability and manual skill etc.; and so there will be quasi-rents from machinery, factories and other buildings, also quasi-rent from business ability and manual skill etc.

In the short period, the supply of these various appliances has not the time to be fully adapted to the demand. The particular income derived from them, in the short period, does not for the time affect perceptibly the supply, nor therefore the price of the commodities produced by these appliances; it is a surplus of total receipts over prime (money) cost. *And this excess of the value of commodities over cost produced by the appliances during the short period, has enough resemblance to the excess value of the produce of land over cost to justify us in calling it a quasi-rent.*

When there is an increased demand for one factor in production which makes its earnings more than normal, some will speak of *positive quasi-rents*. And when conditions arise which make the earnings of a factor in production less than normal, they will speak of *negative quasi-rents*. When the demand for engineers falls off, their earnings become less than normal and they earn negative quasi-rents.

Rent proper and Quasi-rent.

Quasi-rent resembles rent proper in this that it also results from a limitation of supply; quasi-rent* results when the stock of an appliance is temporarily fixed, rent proper of land results from the *permanent* limitation of supply of land.

In the short period, there is a close resemblance between quasi-rent and rent proper. In the short period, the quasi-rent derived from an appliance (the stock of which is temporarily fixed) does not for the time being affect the supply, nor therefore the price of commodities produced by the appliance. The rent from land also does not affect the supply nor therefore the price of the produce of land.

In the long period the supply of an appliance from which a quasi-rent is derived can be fully adjusted to the demand for it; and so if the quasi-rent from the appliance does not in the long run amount to normal

* Quasi-rent is not something like rent but temporary rent (Smart).

profits on capital and effort, the supply of the appliance will dwindle and it would not contribute its part to production. True rent from land will differ from quasi-rent in this way—even if true rent ceased, the supply of the free gifts of nature would remain undiminished and these gifts of nature would continue to take their part in production.

Quasi-rent resembles rent, in the short-period—but not in the long-period.

Like rent, in the short-period quasi-rent from an appliance for production does not affect the supply and the price of the commodity produced; like rent, in the short-period quasi-rent is determined by the price of the commodity.

Rent in the long-period also does not control the supply and the price of the commodity, but unlike rent, quasi-rent in the long-period does control the supply and the price of the commodity produced.

Rent, Interest, Profit.

Socialists regard Rent, Interest, Profit as all incomes of essentially the same nature—each being due to surplus value produced by labour and is the result of the exploitation of labour. They hold that all these incomes are unjust and should be abolished.

From another standpoint businessmen look upon Rent, Interest, Profit as essentially similar, as they are all incomes from property—“all property is valued in terms of its income; all that brings in an income is alike capital, and all is measured or capitalised on the basis of its income.” Some economists follow this view of capital.

Taussig's view is very briefly this: “So far there is . . . ineffectiveness of competition and . . . inequality in return among the instruments made by man their yield presents no phenomena essentially different from those of natural agents. But if there be effective competition between the various forms of artificial capital, no one among them will permanently bring to its owner an exceptional or differential return; then there is interest and interest only on capital in the narrower sense; and then there is a substantial difference between “interest” and economic rent.” As regards social questions and questions of legislation “Interest on artificial capital, as settled under competitive conditions, presents different social problems from those presented by the rent of natural agents or by monopoly gains. . . . Economic rent and monopoly gains are unearned returns, and should be treated differently from return on capital, pure and simple.” (*Principles*, 1926, Vol. II, Chapter 46).

As in Taussig so in Marshall the emphasis is upon the existence of free competition, or otherwise. And there is the question of the elasticity of supply. Marshall's position may be very shortly stated thus in his own words: “A limited stock of large stones harder than diamonds The purchaser would expect them to yield interest on their price. But the net incomes which he actually reaped from them would be governed by the value of their services uncontrolled by fresh supplies dependent on cost. . . . Next suppose that the supply

of stones can be increased slowly; and lastly that it can be increased quickly, and that the stones are quickly worn out The above string of hypotheses begins with rents proper At the other extreme are incomes kept close to interest (or profits) on cost of production Intermediate stages *the fundamental difference between those incomes yielded by agents of production which are to be regarded as rents or quasi-rents and those which (after allowing for the replacement of wear and tear and other destruction) may be regarded as interest (or profits) on current investments. The difference is fundamental, but it is only one of degree. Our central doctrine is that "interest on free capital, quasi-rent on old investments of capital shade into one another gradually even the rent of land being not a thing by itself, but the leading species of a large genus."* (Marshall, *Principles of Economics*, Book V, Chap. ix).

Rent and Social Progress.

Social progress in different directions affects rent in different ways.

(a) Other things being equal, growth of population and of prosperity lead to an increased demand for land, the margin falls and there is an increase of rent.

(b) *Agricultural improvements*, e.g., the introduction of new and more powerful fertilisers, better rotation of crops etc., would enable a given area of land to produce a larger amount of produce, and so the total agricultural produce required by the country would now be obtained from a smaller area of land than before; and therefore some of the poorer grades of land would not be cultivated, the margin of cultivation would ascend, and rent would fall. *Agricultural improvements increasing the produce from a given area of land thus tend to diminish rents.*

(c) *Improvements in means of communication.*

Like agricultural improvements, improvements in means of communication affect the margin and influence rents.

(i) *If these improvements in transportation connect a place with a new market where this agricultural produce can be sold at a higher price, then the rent will tend to increase.* Rents in America have risen with improvements in transport which enable American farmers to produce large quantities of corn for export to England. The demand for agricultural produce for the purpose of export increases the demand for land in America, the margin falls and rent increases.

(ii) *Improved means of communications, connecting a country with a new source of supply of agricultural products will tend to reduce rents in that country.* Increased facilities of communication, the development of steam navigation and railways have made England look upon the United States as a source of supply of agricultural products, the poorer grades of land in England have been thrown out of cultivation by the competition of American produce, the margin of cultivation has risen in England and so rent of agricultural land has fallen.

Improvements in internal means of communications within a country will tend to increase the rent of land distant from the market. The comparative inconvenience of situation of land distant from the market is decreased by improvements in communications.

The unearned increment of land.

Though the idea may be traced in earlier economists, the term "Unearned Increment" was first used by John Stuart Mill.

As the margin of cultivation falls on account of the growth of population and increased demands for produce, the rent of land increases,—and in this way the value of agricultural land may increase without any effort on the part of the landlord. Similarly growth of population and increased prosperity in a town will bring about an increase in ground rents and an increase in the value of urban land. *This kind of increase in the value of land which is due to social progress (growth of population and prosperity), and is not due to anything done by the landlord is called the 'unearned increment of land.'* (Any increase in the value of land brought about by an expenditure of labour and capital by the landlord would be, of course, earned increment, legitimately earned by the landlord).

In Bengal, the Government settled the land revenue with the Zemindars permanently by the Permanent Settlement of 1793. So the Zemindars pay fixed land revenue to the Government, and they (many of them) receive an enormous unearned increment from the land due to growth of population and prosperity. In large towns like Calcutta and Bombay, there is a large and rapid increase in the unearned increment of land.

The argument for the appropriation of the unearned increment by the state.

As the unearned increment is not in any way due to the landlord but is due to the progress of society, in fairness it should be appropriated by society and not by the landlord.

This view has been advocated by John Stuart Mill and also some other distinguished economists, and in an extreme form it has been advocated by Mr. Henry George.

Proposals of Henry George and J. S. Mill, etc.

Proposals for appropriating the unearned increment by the state are of different kinds.

(1) Some propose that the entire unearned increment, past and present, from all kinds of landed property should be appropriated by the state and without any compensation given to the landlords. This is Mr. Henry George's scheme. In Mr. George's scheme, the entire rent is taken by the state from the landlord and the landlord gains nothing from his possession of land. The land practically nationalised becomes, in fact, though not in name, the property of the state.

(2) *John Stuart Mill* proposed (and his suggestion has been repeated by other writers) that the land in a country should be subjected to a periodical valuation by the Government and that any increase in the value of land not due to the labour and capital of the proprietors should be taken over by the state by a tax upon the unearned increment.

The proposal of Mr. John Stuart Mill was chiefly with reference to agricultural land and it was the future increment that was to be taxed.

The suggestion of Mill and that of other reformers of his time have been rejected by many modern economists on certain grounds.

(3) The unearned increment is greater as regards land in towns than in agricultural land and so the taxation of unearned increments in towns finds more supporters at the present day than the taxation of the unearned increment of agricultural land.

The state may take part of the unearned increment or it may take the whole of it by a tax. In some modern states (e.g., England and Germany) the state through taxation appropriates part of the unearned increment. The appropriation of the entire unearned increment has not yet been attempted by any modern Government.

Objections and practical difficulties in connection with the taxation of the unearned increment.

(1) First of all there is the difficulty of ascertaining exactly the amount of the unearned increment. The rise in the value of land is due partly to labour and capital of the proprietor and partly to social progress. And in practice the work of calculating how much is due to the labour and capital of the proprietor, and how much is pure unearned increment is a very complex and difficult task.

A tax taking more than the unearned increment would be unjust, such a tax on agricultural land would discourage agricultural enterprise and is incompatible with good husbandry; and a very heavy tax of

this character on urban land would discourage the effective utilization of urban sites.

(2) Again it is difficult to find out whether the man in actual proprietary possession of the land is getting an unearned increment or not. He may have bought the land from some other man at its full value and here the seller has got the unearned increment and the buyer in possession has got none.

These are practical difficulties in the taxation of the unearned increment.

(3) Then there is an objection on the score of principle. *If the state takes unearned increment due to social causes* (and not to any efforts of the individual proprietor of the land), it is only just and reasonable that the state should pay compensation to the owners of property which is depreciating (not through any fault of the proprietor but through social causes and changing economic conditions); but the state does not pay such compensation.

* Nationalisation of land.

The nationalisation of land means the extinction of all private proprietary rights in land and making all land the property of the state.

The nationalisation of land has been advocated by socialists; and also by persons who are not socialists and who are willing to allow the private ownership of capital (but not the private ownership of land).

Two important systems proposed for land nationalisation are the following :—

(1) The state as owner of the soil should lease the land to individuals, who should cultivate it as tenants of the state.

(2) A second system suggested by John Stuart Mill and brought into prominence by Henry George is to put such a progressive tax* on landed property in the hands of the landlords as would absorb the entire economic rent.

The question arises as to whether this nationalisation of land is to be effected by paying compensation to the present owners of the land or whether the state is to take the land from the private owner without paying any compensation.

(a) Land Nationalisation without compensation.

According to Mr. Montague who writes on this subject in the *Dictionary of Political Economy*, "Nationalisation of land effected

* In India the State has rights over the land from time immemorial and the British Government has recognised also private property in land. "The Indian system of land tenure is something intermediate between complete nationalisation of land and absolute private property in land." (*Indian Industrial Organization—Morison*).

without compensation or with merely nominal and delusive compensation is open to the objections based on law, morals and public policy, which can be brought against the abolition of all property whatsoever and to the additional objection of making one class (the land-owning class) a victim to all other classes."

(b) Land Nationalisation with compensation.

There are also objections to nationalisation of land with compensation.

(1) The difficulty about purchases of the land from the private proprietors.

(a) The total amount of compensation to be paid by the state to landowners will be a very heavy one. How is this amount to be raised by the state? The *fiscal difficulty* would be a serious one.

(b) If the state manages the land itself, a costly public department with an immense staff would be required for the work.

(2) And if land nationalisation is effected with *suitable compensation* to landowners, it will often be *not very profitable to the state* and sometimes it may end in actual loss. If the state in England had bought agricultural land in Mill's time, it would have been a loser on account of the fall in the value of land.

(3) And under the system of a state department granting leases to tenants for varying periods, *the risk of corruption and favouritism* would be great.

(4) The state as landlord may not be able to supply capital as efficiently as private landlords for agricultural improvements and so agricultural improvements and progress be discouraged.

The question of nationalising all the land held in private ownership within a country seems to be difficult under present conditions. As regards future property, that is to say, the concession of new lands granted by the state to citizens (specially in new countries like Australia, Canada and the United States) the state would do well to retain its property in the soil and thus help towards solving the social problem for the future generations.

Land Tenures.

The contract rent taken by the landlord from the tenant often diverges from the pure economic rent of land. *The economic rent* of land is the surplus above cost of production.

The actual contract rent differs from the economic rent on account of economic friction. Where there is ignorance, lack of opportunity or lack of mobility on the part of the tenant, actual rent may be higher than economic rent.

Again where on account of social or other reasons the landowner does not exact from the tenant the whole of the economic rent but only a part of it, the actual rent may be lower than the economic rent.

Tenures.

As Prof. Marshall points out early forms of land tenure are generally based on partnership.

The two partners are (1) the tenant who is the working partner and (2) the state which is the sleeping partner. The produce of the soil is divided between the state and the tenant. This system existed in ancient India and it also prevailed in many other ancient countries.

I. Metayage* or rental by shares.

Under this system the *rent* instead of being paid in money and being invariable during the term of the lease is *paid in kind*. Often one-half of the harvest is paid as rent by the tenant to the landlord, but the proportion is not the same in all places. The tenant supplies labour, he works himself with his family, and sometimes he hires a few labourers, the landlord supplies land and generally also capital in the shape of farm buildings, cattle, and in some cases even farm implements etc.

The metayage system is much in use in certain parts of Europe particularly in Italy, Portugal, and the countries of the Danube, and also in portions of France. We have it here also in Bengal where it goes by different names (*barga, bhagchas, batai etc.*) in different parts.

It is a fact worthy of notice that the proportion of land cultivated under the metayage system has diminished considerably in Europe; and it is also diminishing in India.

Advantages of the Metayage System.

The following advantages can be claimed on behalf of this system.

(1) *Metayage creates a common interest between the landlord and tenant* by making them partners in good fortune and in bad. Under other systems, the landowner and the tenant have conflicting interests.

(2) *A poor man can become a metayer tenant*, because he has not to supply capital. Unlike an English tenant farmer who has to pay the same money rent in good as well as in bad years, the metayer tenant has to pay only a proportion of the actual produce to the landlord as rent; and so even in bad years *the metayer tenant is not in distress about his payment of rent*.

(3) Competition between farmers paying money rents often sends up money rents to an excessively high level, but this is not possible under the metayage system which fixes by custom the shares of the landlord and the tenant.

* For metayage in India, refer to Morison's *Indian Industrial Organisation* (Chapter III).

(4) Again under metayage, the landlord does not gain much by changing his tenant, and so this system is more favourable to *long leases*.

(5) The amount of rent received by the landlord being a share of the produce depends upon successful cultivation; and so the landlord takes interest in the cultivation and sees to its improvement. This benefits the metayer tenants and also improves the standard of cultivation.

The unity of interest between landlord and tenant established by metayage, and the benefits it confers on the metayer tenant are conducive to social peace.

Prof. Marshall holds that the advantages of the metayage system are considerable when the holdings are very small, the tenants poor, and the landlords are not averse "to taking much trouble about small things; but it is not suitable for holdings large enough to give scope to the enterprise of an able and enterprising tenant."

The disadvantages and defects of Metayage.

(1) An able and enterprising tenant would prefer a fixed money rent, because then whatever he produces above that would be his.

Under metayage he has to give a part of the product due to his superior capacity to the landowner. A metayage farmer has also less freedom and responsibility than an English farmer.

(2) And the landlord has to take a great deal of trouble for the land under metayage which he has not to do under the English tenant system.

The land-owner lends capital, and he gets only a portion of the additional net product due to his capital. This seems to be a poor investment to the land-owner, and discourages investment of capital in the land.

For these reasons *metayage* is regarded as being *unsuitable for progressive cultivation*.

The metayage system is not well suited for large holdings requiring a considerable expenditure of capital, and efficient and enterprising management on the part of the tenant.

It has been suggested by Professor Gide that the contract of metayage may be modified according to circumstances, with a view to adapt it to progressive cultivation. The metayer, for example, may contribute a large amount of capital; or the land-owner may advance it at a moderate rate of interest.

II. Peasant Proprietorship.

When the peasant is the proprietor of the land he cultivates, we have the system of peasant proprietorship. The land is his own, he supplies the greater part of the labour working himself with his family and he also supplies the capital. He supplies *land, labour and*

capital; and the entire produce consisting of rent, wages, interest, and profits goes to him.

The system of peasant proprietorship prevails largely in France, in Belgium and in certain parts of the United States. In the United States, the peasant proprietor uses to an important extent hired labour and borrowed capital.

Advantages of Peasant Proprietorship.

The advantages of this system are very considerable.

(1) The peasant knows that he is the proprietor, that the entire product will go to himself. This immensely stimulates his energy and industry.

In the words of Arthur Young "Give a man the secure possession of a bleak rock and he will turn it into a garden The magic of property turns sand into gold."

(2) The system of peasant proprietorship not only makes the peasant most industrious and hardworking, it also improves his character in other ways. The sense of proprietorship gives him self-respect.

And the desire to improve his land by spending capital on it makes him temperate and thrifty in his habits. He is scarcely ever idle and seldom regards his work as mere drudgery; it is all for the land that he loves so well.

(3) Again a large body of peasant proprietors affords a steady bulwark against political and social unrest.

Disadvantages—

(1) Marshall is of opinion that *the peasant proprietor is generally an industrious but seldom an efficient worker*. The peasant proprietors generally stint the food of themselves and their families, sometimes live in their kitchen for economy and are practically worse housed and fed than the better class of English cottagers. The efficiency of peasant proprietorship is therefore low and though they work long hours, they generally get through little work.

Wealth is only a means to an end which is happiness, the *peasant proprietors sacrifice the end (happiness) to the means (wealth)*.

(2) It depresses the birth-rate and prevents a suitable expansion of population. The peasant-proprietor in France practises artificial birth-control and restricts the number of children preventing much subdivision of his land.

(3) The system of peasant proprietorship is not so favourable to scientific cultivation as the English system. The peasant proprietors have not much capital at their disposal and they are also not so educated and enlightened; they do not understand very well scientific improvements and they have also not the means to carry out these improvements.

As regards the disadvantages of peasant proprietorship it may be pointed out that a deliberate check exercised upon the growth of population is confined not only to peasant proprietors but is also to be found among the artisans of the towns and in a very appreciable degree among the upper classes. And this prevention of over-population among the agricultural and the artisan classes is really desirable from their point of view under certain circumstances.

Then for the third objection. Increasing diffusion of education is making peasant proprietors capable of appreciating the merits of scientific cultivation; and co-operation and other suitable agencies are increasing their resources with which they can introduce up-to-date scientific methods and machinery.

The disadvantages of peasant proprietorship are prominent in old countries, where the peasant proprietors are comparatively uneducated, unorganised, and have limited resources.

And in countries where the peasants are properly educated and have sufficient command over capital, peasant proprietorship offers very great advantages. In the words of Taussig "A wide diffusion of the ownership of land and the predominance of cultivation by the owners are the most wholesome agricultural conditions."

India and Peasant Proprietorship.

The Indian peasant is industrious and hardworking. Thrifty he is within limits, and also honest and temperate to a degree. And he has a great love for the land. With more education, and with a sufficient command over capital provided by co-operation and other agencies, he should make an ideal peasant proprietor. At present there is a sort of dual ownership—the landlord has rights of property over the land, and also the tenant who has in many cases occupancy and other rights; and as in Ireland so in India, a large development of peasant proprietorship is expected to do a great deal of good in the future.*

III. The English System of Land Tenure.

In England, peasant proprietorship in some parts existed in the Middle Ages. But in course of time, the peasant proprietors have been replaced by tenants, holding land under the present system of tenure. The present system in England is this—the land of the country is owned by a few great land-owners; the landowner leases the land to the tenant, and the tenant is generally a large capitalist farmer, cultivating the land partly with his own capital and partly with capital supplied by the landlord. The tenant farmer hires labourers on fixed wages to work

* Morison—*Indian Industrial Organization* (Ch. VI).
Ranade—*Essays in Indian Economics*.

for him. So under this system we have the landlord, who supplies the land and also a great part of the capital (about $\frac{5}{6}$ ths of the total capital employed on the farm) in the shape of buildings etc., the tenant farmer supplies part of the capital and the management and there are also hired labourers engaged by the tenant farmer. The lease is for varying periods and generally, for short periods. *The rent is determined chiefly by competition.*

The landlord gets rent which includes some economic rent and also some interest on his capital, the labourers get only wages and nothing more and the tenant farmers receive interest on their capital and profits of cultivation.

Under suitable conditions (*i.e.*, when the landlords are prosperous and not exacting and the tenants capable and industrious), the English system has great merits.

The Merits of the English System.

(1) "The chief merit of this system is" as Marshall points out "that it enables the landlord to keep in his own hands the responsibility for that part of the property (land, buildings and permanent improvements) and only that part which he can look after with but little trouble to himself and little vexation to his tenants.

(2) The landlord supplies $\frac{5}{6}$ ths of the capital and he supplies this capital to the tenants at an exceptionally 'cheap rate (about 3 p.c. interest on cost). This greatly helps the tenants.

(3) Unlike the landlord under the metayage system, the English landlord has considerable freedom in the selection of an able and responsible tenant.

This cheap supply of capital and the selection of able tenants make possible scientific cultivation and a high standard of agriculture. The English system on the whole tends to promote the discovery and diffusion of improved methods and it stimulates and economises enterprise and energy in agriculture.

Demerits.

The English system suffers from certain defects.

(1) The landlords in selecting tenants are not guided by strict business principles. They do not try to get always the ablest tenants, who will make the best use of the land. In this way, there is a loss of efficiency.

(2) The dependence on the landlord is distasteful to many able men who would prefer the system of peasant proprietorship; and these men, in the absence of peasant proprietorship would engage in manufacturing and other industries rather than engage in agriculture.

(3) The position of the labourers is not a satisfactory one, they get only wages and have no other interest in the land.

Marshall remarks "faulty and harsh as it has been in many respects, it yet had a great power of stimulating and economising that enterprise and energy . . . which gave England the leadership of the world in manufacture and colonization and though in a less marked degree in agriculture."

The Introduction of Peasant Proprietorship in England.

Prof. Marshall is of opinion that for England the present system is on the whole the best, and peasant proprietorship is unsuited to the economic conditions of England, to her soil and climate and the temper of her people.

Marshall however points out that *within certain limits peasant proprietorship as a system of land tenure has its place even in England.* There are certain types of men who have a great capacity for growing fond of the land, who would work hard and live sparsely if they have not to call any man their master and these men are specially fitted to be peasant proprietors; and there should be no artificial hindrances to their acquiring peasant properties.

Conditions and limitations on large-scale production in agriculture.

Large-scale production in agriculture cannot be carried to the same lengths as in manufacture. The causes of this are the following :

(a) Agriculture must be spread over the broad land, thousands of agricultural workers cannot be concentrated on a small area; and agricultural operations are not easily subjected to a fixed routine. Both these circumstances make effective supervision difficult.

In manufactures, on the other hand, thousands of workers can be concentrated within a small area, even under a single roof and the work may be divided into routine tasks of different kinds assigned to different classes of workers. This makes effective supervision in manufacture even on a large scale possible. And so large-scale production is carried to much greater lengths in manufacture than in agriculture.

(b) In agriculture there is a great dependence upon the seasons and the use of machinery is not so large as in manufacture. These things also work against the establishment of large-scale production in agriculture to the same extent as in manufacture.

The scale of farming in each country depends upon various economic, political and social factors.

In England farming is on a larger scale than in India. Even in England however an increase in the scale of agriculture is prevented by the following facts :

(a) High-grade business ability is required for successful large-scale agriculture. In agriculture the farmer has to do the higher work of

management and he has also to waste his time upon much work which is really below him. The earnings of business abilities are therefore not so high in agriculture as in manufacture and other industries, and so the best men leave agriculture for other occupations.

(b) Again an increase in the scale of agriculture will require farm buildings and means of communication specially adapted to it.

India and large-scale agriculture.

In India, of course, we have the general limitations on large-scale agriculture which exist in all countries. We have in addition the following circumstances limiting the scale of production in Indian agriculture:

- (1) The system of small holdings.
- (2) The law of inheritance which favours subdivision of holdings.
- (3) Absence of suitable agencies for supplying cheap agricultural capital.
- (4) We have not also a capable class of farmers having that knowledge of scientific agriculture, machinery, and markets, necessary to make large-scale cultivation a success.

Rent defended. Its social and economic justification.

Rent has been assailed by socialists as a form of theft, as surplus value stolen from labour. (Cf. the socialist theory of value in Vol. I. page 441).

It has been strongly defended—even on social grounds. Economists maintain that private property in agricultural land has stimulated production and social interests through the long course of civilisation. "Private property in agricultural land has been developed in the course of long centuries as the most effective means of spurring on the cultivator to the best methods, and thus uniting individual and social interests. To distinguish between the social and individual causes of agricultural rent is impossible. The validity of agricultural rents, however, involves that of other land rents as well." (Seligman—*Principles*). So also Tausig. "The spur of ownership was historically indispensable for the advance of the agricultural arts. . . . Hence all communities, whether they have moved slowly through a long historical development or have begun at once on the plane of advanced civilisation, have rested their industrial organisation on private ownership of land. . . . To destroy all these acquired rights is not indeed unthinkable, but it would involve reconstruction of the whole framework of society. It presents the problem of socialism . . ."

Mr. Henderson (in his *Supply and Demand*) maintains the necessity of Rent not only under existing conditions but even under socialism. "The way in which the land of a country is used, the way in which it is apportioned between the countless alternative employments that

are possible, is a most important matter, more important perhaps than any questions as to the size of the incomes which particular landowners receive by virtue of their rights of ownership. How is this apportionment effected as things are now? The answer is clear: mainly by the agency of either rent or price. The business which finds it worth while to offer the highest rent or the highest price for any piece of land will, as a rule, be able to command its use. And, with this as the governing principle an apportionment is secured between shops, offices, factories, agriculture. . . ." So even under socialism (though there might be no private landowners) rent would be necessary to bring about the best social utilisation of the land as between the immense variety of different employments.

Summary.

1. *Rent in economics* is used to mean (i) income from land and other free gifts of nature and (ii) *in a wider sense* payment for any differential advantage in production enjoyed by any agent in production (*viz.* land, labour, capital or organization).

2. Ricardo's contribution to the theory of rent is very important. Rent, according to Ricardo, is paid for the indestructible properties of the soil, and it is a differential return. Historically the best land is cultivated first, and (to meet the growing demand for produce and on account of the operation of diminishing returns) worse and worse grades of land have to be cultivated. As the margin of cultivation descends, rent increases. Rent is not an element in the price of agricultural produce.

Objections.

Some objections usually urged against the Ricardian theory are that (i) rent is not paid for the indestructible properties of the soil, (ii) the best land is not always cultivated earlier than the inferior grades, (iii) the Ricardian theory of rent does not apply to actual conditions in many countries, (iv) rent in certain cases does enter into price.

3. Prof. Marshall's re-statement of the classical doctrine of rent gives a clear and comprehensive explanation as to how margin of cultivation, the amount of produce, the amount of rent, and the price of produce are determined, and the relations between them. Rent is a surplus above cost.

4. There is an intimate connection between the law of diminishing returns and rent. Without diminishing returns there would be no rent.

5. The *rent of agricultural land* is due to differential advantages relating to fertility and also convenience of situation. *Rent of mines* includes (a) rent proper and (b) a payment as compensation for the exhaustion of minerals. Situation is the factor of special importance in determining the rent of urban sites.

6. Actual rents are less than the economic rent in England under the influence of public opinion and class sentiment; they are less than the economic rent in many countries of Europe under the metayage system on account of the influence of custom, but were greater than the economic rent in Ireland sometime ago.

7. Rent is not an element in the price of agricultural produce—the payment of rent does not affect the price of produce in the market. Rent is not the cause of the high price of produce, but high rent is rather the effect of the high price of produce.

8. The value of agricultural produce determines rent; and rent in turn determines the value of land.

9. In the short period the net incomes from the appliances for production (*viz.* machinery, factory buildings, business ability etc.) have enough resemblance to true rent to justify us in calling them *quasi-rents*.

10. Rent is affected by *social progress* in different ways. The causes which make the margin of cultivation fall bring about an increase of rent, and the causes which make the margin ascend bring about a fall of rent.

11. The argument for the *taxation of the unearned increment* is this. The unearned increment is something which is not earned by any expenditure of labour and capital by the landlord, but is due to social progress, and so should be appropriated by society.

Objections. The usual objections advanced against the taxation of the unearned increment are that (i) the state is not justified in taxing unearned increment because it does not pay compensation to owners of depreciating property, (ii) practical difficulties about (a) ascertaining the exact amount of the unearned increment and (b) finding out the person who is in actual enjoyment of the unearned increment.

12. *Nationalisation of land* may be (a) with compensation (b) without compensation to the existing proprietors of the land. Nationalisation without compensation is opposed to law, morals and public policy. And as against nationalisation with compensation, the principal objections are (i) the fiscal difficulty in connection with the purchase of the land by the state (ii) the expense of managing the land by a costly public department (iii) the risk of corruption and favouritism.

13. The *metayage system* has very considerable advantages when the holdings are small, the tenants poor and the landlords willing to take a great deal of trouble but ordinarily it is not quite suitable for progressive cultivation. The *English system* with all its defects and harshness is well adapted for scientific cultivation and a high standard of agriculture, and has great power of stimulating and economising energy. The system of *peasant proprietorship* suffers from certain defects in countries where the peasants are ignorant, unenterprising and have limited resources; but it offers very considerable advantages, and it is the most wholesome system where the peasantry have education, energy, organization and a sufficient command over capital. Marshall admits that within a limited sphere, there is scope for peasant proprietorship even in England, but there are obstacles to be overcome.

Questions.

1. What are the different senses in which the word 'rent' is used? What do you understand by factors of marginal capacity, and factors of supermarginal capacity?
2. State and examine the Ricardian theory of rent. (C. U. 1912, 1910).
"Rent is paid for the original and indestructible powers of the soil". Discuss. (C. U. 1928).
3. (a) Give briefly Marshall's re-statement of the classical theory of rent.
(b) How is the economic rent of land determined? Would there be any economic rent if all lands were equally fertile? (C. U. 1929).
(c) What is the relation of the Law of Diminishing Returns to Rent? (C. U. 1911)
4. Describe how (a) rent of agricultural land (b) rent of mines (c) rent of building sites are determined.
"Land rent is a differential or surplus product." Explain this statement and discuss the nature of building rents. (C. U. 1927).
5. (a) Discuss the proposition "Rent is not an element in the price of agricultural produce." (C. U. 1919, 1921).
(b) How is rent related to price? (1911 H.).
(c) What is the relation between the rent of land and the price of land?
6. Do actual rents in England, in continental metayer countries and the United States correspond to the rent of Ricardian theory?
7. (a) Write a note on Quasi-rent. (C. U. 1914, 1926).
(b) Explain Quasi-rent and discuss the relation between Quasi-rent and true Rent (1912 H.).
8. Discuss the effect upon agricultural rent (a) of agricultural improvements (b) of improvements in internal means of communication (c) of opening up of a new source of supply of agricultural products. (C. U. 1912).
9. What is nationalisation of land? Consider the questions of (a) nationalisation with compensation (b) nationalisation without compensation.
10. Give short sketches of the following systems of land tenure pointing out merits and defects:
(a) The metayage system (b) peasant proprietorship (c) the English system.
11. Remark on the characteristic merits of peasant proprietorship.

CHAPTER III.

WAGES.

* The Wages Question.

In modern industrial communities like England, France, Germany and the United States, most men (and a large number of women) are wage-earners. For the vast majority of the people in these countries, the wages question is the great economic question, the fundamental problem relating to their economic status, prosperity and progress.

The problem relating to wages is one of great complexity influenced by an immense variety of factors, economic, political, social and ethical. "The wages question is a question of culture."—*Brentano*.

Wages.

Definitions of Wages.

(1) *Prof. Gide's view.*

The word "Wages" is sometimes defined by economists to mean the income received by a person for his labour. This definition is regarded by Prof. Gide as too wide.

And Prof. Gide remarks that the term wages should be applied only to the remuneration for labour, performed under certain conditions, *the wages should be applied* not to mean the

* In countries like India which have not yet fully adopted the modern industrial organisation, large numbers of workers are not wage-earners employed by a big employer but they are their own masters working as independent producers on a small scale. The average Indian peasant is an independent producer working on his own account, and not a wage-earner employed by a master; and there are multitudes of these small producers in the Indian handicrafts and cottage industries. There are great numbers of wage-earners in India, but they form a much smaller proportion of the population in India than in England or the United States.

So there is a measure of truth in Sir T. Morison's statement "The rate of wages is a matter of very slight concern to the working class of India" (*Indian Industrial Organisation*).

price of every kind of labour, but to the price of labour, hired and employed by an entrepreneur.

(2) Some writers use the expression *wages in a wide sense* to mean the price paid for the services of labour. And by labour they include all the various kinds of personal services, for which a payment is made. The word "Wages" in this sense means the earnings of labourers hired by the entrepreneur, the earnings of the entrepreneur himself for his labour of superintendence, the earnings of professional men, etc.

The entrepreneur for his own labour of superintendence gets an income called the wages of superintendence. So the term wages is applied not only to the income of labourers hired by the entrepreneur, it is also used to mean a part of the income of the entrepreneur himself.

Real and Nominal Wages.

The *real wages* of labour are the remuneration of the labourer reckoned in the necessities, and conveniences of life that are given for labour. The *nominal wages* of labour consist of the quantity of money paid.

To quote Adam Smith "The *real wages of labour* may be said to consist in the quantity of the necessities and conveniences of life that are given for it (labour); its *nominal wages* in the quantity of money.....The labourer is rich or poor, is well or ill rewarded, in proportion to the real, not the nominal wages of his labour."

Marshall goes on to point out that the words "that are given for it" must not be taken to apply only to the necessities, conveniences that are directly provided by the purchaser of labour or its products; for account must be taken also of the advantages which are attached to the occupation and which require no special outlay on his part."

Two labourers earning the same nominal wages may have very unequal real wages.

In calculating the real wages of an occupation at a particular time and place we have to allow for (a) variations in the purchasing power of money. We must pay special attention

to those things on which the class of labour in question spends most of its wages.

(b) Allowance also must be made for all *trade expenses*. The net income of the barrister (or of the doctor) is his gross income minus his trade expenses like the salary of a clerk, the cost of keeping a carriage etc.

(c) We must allow for the *certainty or uncertainty of success* and the *regularity or irregularity of employment* in the occupation.

(d) We must take into consideration opportunities, which the surroundings afford, of any *supplementary earnings* for the man engaged in the occupation or for other members of his family.

(e) Allowance also must be made for *varieties in the form of payment* as when certain quantities of food and drink or the rent of a cottage etc., are given by the employer to the labourer in addition to the money wages.

(f) *The longer duration of labour power* in some occupations in some countries must also be taken into account. If two labourers work at the same nominal wages in two occupations, that one receives the higher real wages who lives longer than the other.

We must also take into consideration that one occupation is healthier than another, or that it gives a better social position, or that it is more or less dangerous to life and limb, or it offers chances of high rewards to some members of the occupation, and so on.

The attractiveness of an occupation to a labourer depends not upon money wages but upon the real wages, the net advantages of the occupation.

In comparing the relative prosperity of labourers in different countries, we have to compare not their money wages but their real wages. Money wages may be the same in two countries, but real wages may be higher in one country than in the other, and the labourers in the country with higher real wages will be better off.

Prof. Seligman uses 'real wages' in a somewhat restricted sense. "Money wages are actual wages paid in money ; real

wages are actual commodities that the money wages can buy." He seems to exclude other advantages attaching to the occupation.

Time wages, piece wages, efficiency earnings.

The earnings or wages of a person in any given time, such as a day, a month or a year constitute his *time wages* or *time earnings*.

We have a system of *piece work wages* when wages are paid in proportion to the quality and the quantity of the work done by the labourers.

Wages paid in proportion to the ability and efficiency required of the labourer are called *efficiency earnings* or *efficiency wages*. In the words of Prof. Marshall "The tendency of economic freedom and enterprise to cause everyone's earnings to find their own level is a *tendency to equality of efficiency earnings in the same district*."

Wages and cost of labour to the employer.

For the employer *low-waged labour which is inefficient is really dearer than high-waged labour which is efficient*.

This is the economy of high wages and its truth is very well realised by shrewd business men all over the world and specially in America. A simple illustration will make the thing clear. *To the employer, cost of labour is high or low according as he gets a small or large return for the wages he pays*. One labourer earns one pound a week and produces work worth two pounds. Another labourer earns higher wages, *viz.*, two pounds a week but he produces work worth five pounds. Surely it is the labourer with the higher wage, who is cheaper to the employer because for each pound of wages, which he gets from the employer, he gives to the employer a larger product than the low-waged labourer.

An average labourer in an Indian cotton mill receives wages per day much lower than an average labourer in an English mill but the low efficiency of Indian labour makes the cost of labour to the employer higher in India than in England.

Of two labourers, one earning a high wage and the other earning a low wage, on account of the difference in efficiency (and both using the same quantity of machinery), the high-wage labourer is cheaper to the employer because for every pound of wages he does a larger amount of work for the employer with the same quantity of machinery.

Some peculiarities in connection with the demand and supply of labour.

Prof. Marshall notices the following peculiarities in the action of the forces of demand and supply with regard to labour, which are of importance in the theory of wages.

(1) *The worker sells his work but retains property in himself, (he does not sell himself like a commodity or any material agent of production).*

The investment of capital in him is limited by the means, the forethought, and the unselfishness of his parents.

(2) *The seller of the labour must deliver it himself.* And it is a matter of importance to him that the place where he is to labour is a healthy one, where he will have good associates and other advantages.

(3) *Labour is perishable.* If a labourer does not work for some days on account of loss of employment, his labour for those days is irrevocably lost and cannot be recovered.

(4) The sellers of labour are generally poor, they have *no reserve fund* and they cannot easily withhold the supply of their labour from the market. For these reasons, labourers generally speaking are at a great disadvantage in their bargaining with employers.

(5) Another peculiarity consists in the *slowness of the growth of new supplies of labour.* It takes time to prepare and train labour for its work and the returns from the training also come slowly.

It is to be noticed that in these respects the position of the Indian labourer is generally much weaker than in England and other countries where labour is educated, efficient, well-organized and better paid.

Is there a general rate of wages?

Economists are divided on this question. The two different and opposed views are given below.

(A) *There is no general rate of wages.*

There are different kinds of labour and so there are different rates of wages.

(i) *Carver.*

There are almost as many kinds of labour as of products and it will be quite as unreasonable to find a general rate of wages for labour as to find a general price for products.

(ii) *Marshall.*

So also Prof. Marshall. "There are no such things in modern society as a general rate of wages. There are as many different rates as there are occupations and each trade, profession and occupation has its own wage problem."

(B) *Seligman.*

There is a general rate of wages in the sense that it varies comparatively little as between a substantial minimum for the bottom grade and a not very much greater return for the higher grades of those labourers whose numbers are of importance. In this sense, Seligman says there is a rate of wages like a rate of interest.

We use the term 'general level of prices' and we speak of the rise and fall of prices. Similarly we may speak of a general rate of wages and a rise or fall in the level of wages.

Theories of Wages.

(1) Theory of the Iron Law of Wages.

According to the advocates of this theory labour is a commodity. Workers are the sellers and employers are the buyers of this commodity. The value of a commodity is determined by its cost of production. And what is this cost of production of labour?

The cost of production of labour consists of necessities required to maintain the worker and his family.

The value of labour (i.e., wages), is determined by this cost of production, (i.e., the minimum necessary to maintain a labourer and his family).

This theory of wages was started by the Classical School and received support from Ricardo in England, and Say in France. And under the name of the Iron Law, it has been used by the Socialist Lassalle to attack the existing distribution of wealth.

This theory of the iron law of wages is now rejected by scientific economists and it has been abandoned even by the socialists.

The objections to this theory are clear and overwhelming—

(1) This theory cannot satisfactorily explain the inequality of wages in different occupations in the same country.

The necessities required by an unskilled labourer are practically the same as the necessities required by a labourer engaged in skilled occupations like electrical engineering etc., but the wages in skilled and unskilled occupations are different. The theory cannot also properly explain the inequality in wages in different countries or at different times.

The amount of necessities consumed in different countries or at different times by an ordinary labourer may be much the same and yet the wages may be different.

(2) This theory takes notice only of the *supply side of labour* i.e., the number of labourers and it neglects the *demand side*.

And as regards the supply side it makes the mistake of holding the view that the supply of labourers is determined simply by the necessities of existence.

(3) Again as Prof. Gide points out the theory is either too optimistic or too pessimistic.

The theory is too optimistic if it holds that wages cannot fall below necessities of existence—in the worst paid occupations wages do actually fall below necessities. The theory is too pessimistic if it maintains that wages cannot rise above necessities—the wages of labourers in most of the skilled occupations are much above the necessities of life.

(2) The residual claimant theory of wages.

This theory has been developed by Walker, one of the most original thinkers among the economists of America. The substance of Walker's theory is this—

The labourer is not a commodity, he is an instrument of production and the value of his labour depends upon his productivity.

* Walker.

Wages strictly form the residual share of the product of industry, residual in this sense that it is enhanced by every cause, whatever that may be which increases the product of industry without giving to any one of the other three agents of production a claim to an increased remuneration under the operation of principles already stated: residual in the sense that, even if any one or all of the other agents of production become so engaged in any given increase of the product as to become entitled to an enhanced share in its distribution, their shares still remain subject to determination by positive reasons, while wages receive the benefit of all that is left over after the other claimants are satisfied.

Wages are determined by the productivity of labour.

And the wage-earner is the residual claimant in distribution. He is the residual claimant in the sense that he receives all that remains of the total product when the shares of the other agents of production (viz., rent, interest, profit) have been deducted. (Wages = total product of industry - rent - interest - profit).

Rent, interest and profit are fixed by the laws of rent, interest and profit; and as there is no law for fixing the amount of wages to be paid, all that remains of the value of product goes to the labourers as wages.

When there is no additional demand for land, the rent (of land) cannot rise, when there is no additional demand for capital there is no rise in the rate of interest, when there is no additional demand for employing ability profit also cannot increase; and if under these circumstances there is an increase in the amount and value of product (due to invention of machinery or due to the improvement of organization or to quality of labour) the whole of the increased value will go to labour as the residual claimant.

Criticism of the residual claimant theory.

(1) If the labourer is the residual claimant then combinations of labourers (trade unions) cannot raise wages because trade unions cannot increase residual shares. As a matter of fact trade unions raise wages and so the residual claimant theory fails.

(2) The residual claimant theory does not take into account the influence exercised by the abundance or the scarcity of labour upon the rate of wages. This is a serious omission.

(3) Walker, the propounder of the residual claimant theory, himself recognises that this theory will apply to the wages of labour only under certain conditions—he maintains that labourers will get the residual shares “unless by their own neglect of their own interests, or through inequitable laws, or social customs having the force of law” they are deprived of a portion of it by the other agents of production.

And in actual practice these conditions are often not realised so the residual claimant theory ceases to apply to actual wages.

(3) * The Wages Fund theory.

The wages fund theory was during fifty years (1820-1870) the accepted doctrine of English economists on the subject of wages

*** A short history of the Wages und theory.**

The wages fund theory was the wages theory of the English economists of the classical school for about half a century (1820-1870).

In Malthus we find that a certain fixed proportion of the total food

has been much criticised and is now generally rejected.

The substance of the theory is this:

The total amount of wages paid in a country depends upon the amount of capital set apart for paying wages. The amount of capital set apart for paying wages is the circulating capital of the country and it is called the wages fund.

The demand for labour consists of this wages fund for paying labourers and the supply of labour consists of the number of labourers. Wages (that is the average rate of wages) depend upon the supply of and demand for labour, wages are determined by dividing the wages fund by the number of labourers.

$$\frac{\text{Wages Fund (circulating capital)}}{\text{Number of labourers}} = \text{Average rate of wages.}$$

If the wages fund amounts to 30 million pounds and if the labourers number 2 million, then the average rate of wages will be £15 per labourer.

produce of a country (and this total produce also is supposed to be fixed in amount) is supposed to go to the labouring classes.

James Mill substitutes capital for goods in his reasonings. John Stuart Mill adopts his father's doctrine with some modifications and gives final shape to the wages fund theory.

"Wages depend on the proportion between population and capital. . . . wages meaning of course the general rate cannot rise but by an increase of the aggregate funds employed in hiring labourers, or a diminution in the number of competitors for hire. . . ."

Mr. F. D. Longe's and Thornton's attacks on the wages fund theory led Mill in 1869 to make his celebrated recantation and to acknowledge that he had been wrong in his statement of the theory of wages.

Even after Mill's surrender, the theory of the wages fund was defended by Prof. Cairnes who attempted to reply to the arguments of Longe and Thornton.

The theory however completely collapsed after the attack on it by Prof. Walker in "The Wages Question." He maintains that wages are in no sense determined by the proportion between population and capital and that wages are paid out of the product of present industry and hence production furnishes the true measure of wages.

Walker and certain other economists have wholly and completely rejected the Wages Fund theory (1) they have maintained that there is no fixed wages fund and, (2) they deny that wages are ultimately paid out of capital.

As against these writers Tausig has attempted and with considerable success a partial defence and reconstruction of the Wages Fund Theory. He tries to prove that (1) wages are advanced out of capital (2) wages funds in the hands of the capitalists though not absolutely fixed are roughly predetermined and yet elastic within considerable limits. According to him, the wages fund doctrine bears not on the permanent and unalterable relation of real capital to real wages but on the relations of certain kinds of labourers (hired labourers) to the capitalists of our modern communities. (Tausig—*Wages and Capital*).

Conclusions from the Wages Fund Theory.

The advocates of the wages fund theory draw the following conclusions from the theory.

(a) Wages can be increased only by increasing the circulating capital of the country or by diminishing the number of labourers.

(b) If there is no increase in the circulating capital or no diminution in the number of labourers, then the attempt of one class of labourers to increase their wages will either fail or will succeed only at the expense of wages of other classes.

The wages fund theory is thus very pessimistic as regards the future of the working classes. And so it has been very unpopular with them even before its rejection by scientific economists.

Criticism of the Wages Fund theory.

(1) *Wages are not paid out of capital; they are only advanced out of capital. Wages are paid ultimately out of the product of industry. Wages come from the national dividend and the national dividend is not a fixed fund but it is a flow or income stream.*

The labourers by increasing their productivity will increase the national dividend and can thus raise wages without increasing the so-called wages fund.

[Any other cause which increases the national dividend makes possible an increase of wages, other conditions being favourable.]

(2) *The amount of capital from which wages are advanced is not rigidly fixed as is assumed in the wages fund theory. There is no fixed wages fund. It is an elastic amount and it will increase with an increase in the remuneration for capital.*

(3) The wages fund theory implies that there is a national wages fund set apart for hiring labour; and of course this national wages fund must be a total of individual wages funds in the hands of individual employers. As a matter of fact there are no such individual wages funds set apart exclusively for hiring labourers and for doing nothing else.

(4) The wages fund theory makes the mistake of neglecting the fact that an increase in the number of labourers increases the product to be divided.

(5) The unsoundness of the wages fund theory is also proved by the following cases:

(a) If the wages fund theory were correct then wages would necessarily fall after a war on account of the destruction of capital and the consequent decrease in the national wages fund. But actually wages do not always fall after the end of a war.

(b) Again if the wages fund theory were true, wages would always fall after the end of a crisis which destroys part of the national capital. Actually however, this does not always happen.

(c) According to the wages fund theory wages would be low in a new country with its smaller accumulation of capital, high in old countries with their larger supplies of capital. We often find, however, that wages in new countries are higher than in old countries.

(d) Again strikes often increase the wages of labourers without in any way increasing the wages fund.

Such cases which cannot be explained by the wages fund theory and which are arguments against the theory can be multiplied.

Mill's two propositions relating to capital which support the Wages Fund theory and Marshall's examination of them.

(1) One proposition is that *industry is limited by capital*. From this Mill argues that industrial activity independent of the growth of capital cannot raise the rate of wages. In answer to this Marshall says that the proposition that industry is limited by capital can be explained so as to be true but a similar explanation would make the statement that capital is limited by industry equally true. (This proposition is used by Mill to show that since protection cannot increase capital and since industry is limited by capital therefore protection cannot increase industry. The cause of free trade however does not need the support of such a weak argument, it is strong enough in itself).

(2) Another proposition of Mill is *demand for commodities is not demand for labour*. Marshall says that this proposition expresses Mill's meaning badly. The proposition may mean two things :

(a) It is not always true in the sense that the direct hire of labour is more beneficial to the labourer than to spend it on buying commodities.

(b) It is true in the sense that if a consumer of ready made articles becomes a producer and an employer of labour and postpones his own consumption of capital and pays wages with it, then he does some good to the labourers. But the same postponement would have resulted in the same benefit to labour if the purchaser had made no change in the mode of his expenditure.

(4) Demand and supply theory of wages.

The price of labour depends upon the demand for and the supply of labour. The employer's demand for labour depends upon the marginal productivity of labour (the net product which the marginal labourer contributes). The demand price for labour is governed by its marginal productivity. (See general theory of distribution pages 293-294).

The supply of labour depends upon the number of labourers and also the efficiency of labour.

The total supply of labour may be increased, either by increasing the number of labourers or by increasing their efficiency or by increasing both. The factors which regulate the efficiency of labour are comparatively simple but the factors which regulate numbers are more complex. In considering the question of numbers, we have to consider the general law of population. It is the standard of living which chiefly determines the rate of growth of population in rich and progressive countries; and the standard of living means the number of other wants whose satisfaction the individual considers of more importance than marriage or family. The standard of living may be said to influence wages just as the cost of production of a commodity influences its price by limitation of the supply.

The standard of living affects the supply of labour, (1) partly by increasing the age of marriage and by restraining the increase of numbers and (2) also by increasing the efficiency of labour. (A rise in the standard of living for workmen increases their efficiency because such a rise means better and more plentiful food, clothing and house accommodation for these workers, and also larger leisure and improved opportunities for education. Other things being equal, a restriction in the size of his family enables the workman to maintain a high standard of living for himself and his family; but with high productivity of labour as in a new country, the workman is able to maintain a high standard of living even with a large family, and his growing sons are helps and not hindrances to the settler in the rich soil of a new country).

In the long run, a rise in wages generally increases the number of labourers and also increases efficiency by raising the standard of living. A fall in wages reduces the number of labourers and also reduces efficiency. (The rate of wages that is sufficient to attract a certain quantity of a particular kind of labour is the *supply price* of that labour.)

When the demand and the supply prices of labour of a particular kind are the same, we have an equilibrium of demand and supply and an equilibrium rate of wages.

Suppose we are considering a particular class of semi-skilled workers in an Indian district.

Wages	Demand	Supply
Rs. 20/- per month for a labourer.	20,000 labourers.	16,000 labourers.
Rs. 25/- " "	17,000 "	17,000 "
Rs. 28/- " "	15,000 "	18,000 "

As the price of a service (or a commodity) increases, the demand decreases and the supply increases. In this case we have Rs. 25/- per month, the equilibrium rate of wages, bringing about an equilibrium in the demand for and supply of labour.

Mobility of labour.

The supply of labour is adjusted to the demand for it by the mobility of labour. This mobility consists (a) in the movement of adult labourers from one occupation to a more profitable occupation (b) in the growth of new supplies of labour from the children of labourers who grow up to manhood.

Vertical mobility means the power of labour to move from one industrial grade to another. *Horizontal mobility* means the power of labourers to move from one occupation to other occupations of the same grade. There is only a small degree of vertical mobility; but the amount of horizontal mobility is already very considerable and it is increasing on account of the increasing diffusion of education and the breaking up of the barriers between different trades through the introduction of machinery.

Dobb's theory of wages.

Maurice Dobb, a Cambridge economist, gives a new refinement of the Supply and Demand Theory of Wages—his "new theory, while it is apparently different in form and phrasing, is fundamentally fairly similar to the doctrines which preceded it. Like its predecessor, it is to be classed as a Supply and Demand Theory, modified and a little more complex. The fact that the level of wages may react on the efficiency of the worker, and so affect his output, is recognised..

The Demand for Labour. The Wages-Fund available for employing labour is no longer regarded as a quantity bearing a fixed proportion

to the surplus produce of industry which accrues as income to the owning class. It is a fund which may be added to or reduced by the action of investors according to the relative attractiveness of investment as against present enjoyment.

The Supply of Labour. The supply of labour will also tend to be an elastic thing, but elastic only within limits, these limits being similarly determined by the "supply-price" of labour.

The wage-level is then seen to be dependent on two variable quantities—the amount of capital advanced to hire labour (or the "Wages-Fund") and the supply of labour forthcoming. The former at any one time will depend on past accumulations of capital, but will be modified in the course of time by the investor's willingness to add to existing capital by new investments, or, on the other hand, by his unwillingness to leave existing accumulations of capital intact and his preference for transferring them to his own consumption As an equilibrium in mechanics may be the resultant of two opposing and resisting forces, so wages are regarded as the resultant of the two resistant forces of the investor's desire to spend his money and the worker's dislike of work.

The "Supply-Price" of Labour. this "supply-curve" being as much determined by the level of wages as wages were determined by it.

The poorer the worker, the lower the "supply-price" of his labour—the more work he will do for a given wage. The wage he gets to-day may be the most important factor determining the wage he is willing to accept to-morrow; and his existing poverty may be the principal reason of his wages remaining low.

For this reason the "economic freedom" of the worker will be a factor of prime importance affecting the wage-level. Institutional changes, such as enclosures and the elimination of the independent artisan which were described in Chapter I, will not affect the wage-level only be increasing the number of people in the labour market: they will affect it by cutting the worker off from other means of livelihood, and so making him more dependent on wage-earning than before and more willing to work for lower wages

The Influence of Bargaining-Power. It follows from this view that over a considerable range wages can be affected by bargaining, in so far as the latter raises or lowers the "supply-curve" of labour. If the bargaining power of the workers is strengthened, the price of labour per unit can be raised; if the bargaining-power of the workers is weakened, the price of labour is likely to fall"—Maurice Dobb, *Wages*, 1928, pages 85—97.

Maurice Dobb refers to inventions in relation to wages. He attaches great importance to the influence of bargaining-power on wages, holds that as regards England, there is "a maximum possibility, with conditions remaining as they are, of wages being influenced in an upward direction by bargaining to the extent of about 20 per cent."

Taussig's theory of wages.

Prof. Taussig says "The simplest and clearest mode of stating the theory of general wages is, in my judgment, to say that wages are determined by the discounted marginal product of labour."

Now the expression *marginal product* is obvious enough. But what is *discount*? Discount implies an advance. Production under modern round-about methods takes time, and the labourers are maintained during this period by advances from capitalists.

The capitalist-employer advances to the labourers as wages less than what the labourers eventually produce, the capitalist-employer discounts the product of labour, and thus makes his gain.

The practical man readily sees that the labourer cannot be paid as much as the product will sell for; otherwise nothing will be left for the employer and the capitalist. *And at what rate will the future product of labour be discounted?* Taussig says that normally the rate of discount is the *current rate of interest and the current rate of profit for that particular kind of business; and the product of labour being thus discounted will give the rate of wages.*

Criticism of Taussig's theory.

Prof. Taussig himself anticipates and attempts to answer the two following objections to his theory :

(1) *The doctrine that wages depend upon the discounted marginal product of labour is a dim and abstract one remote from the problems of real life.*

(2) If we argue that the rate of interest depends upon the excess of what the labourers produce in the future over what is advanced to them in the present, the rate of interest would then *result* from the process of advances to labourers, it could not also regulate or determine the amount of these advances. *The theory thus involves the risk of arguing in a circle.*

(3) A third objection is this. Taussig like Walker makes the labourer a residual claimant. The labourer gets what is left of the product of labour after deducting interest and profits at the current rates. The shares of the capitalists and employers are determined by certain fixed laws and whatever remains of the product of industry goes to labour as the residual claimant. The criticism of Walker's residual claimant theory applies to the theory of Taussig.

Different rates of wages in different occupations.

Other things being equal, *wages in different occupations are proportional to the efficiency and exertion required in each of them. In each occupation, the wages of the labourers depend upon the relation between the demand for such labourers and*

the supply of such labourers and upon the relative bargaining strength of the labouring class and the employing class.

There are special considerations to be borne in mind in any attempt to explain the differences of wages in different employments.

Some causes of differences of wages in different employments are the following :

(1) *Agreeableness or disagreeableness* of the employment. Other things being equal, an agreeable occupation would command a lower rate of wages than one not agreeable.

(2) *The ease or difficulty of learning it* and also the *expense of training*. Other things being equal, an occupation requiring expensive training tends to have a high rate of wages.

(3) *The regularity or irregularity of employment*. Irregularity of employment has to be compensated by high wages when employment is available.

(4) *Certainty or uncertainty of success*.

(5) *Supplementary earnings* and any *incidental advantages* like gifts of food and drink or rent-free houses, etc. (6) *social advantages or disadvantages* (7) whether the employment is a healthy one or not, whether it is dangerous or not. In dangerous employments, wages are generally high.

In other words *the attraction of an occupation lies not in its money wages but in its net advantages* ; and low money wages may be compensated by other advantages.

Mobility is an important factor. Other things being equal, efficiency earnings tend to be equal in different occupations when there is perfect mobility. Want of mobility produces differences in wages for the same kind of work in different occupations. The wages in certain occupations (e.g., wages of the doctor or of the solicitor) are high because of this absence of mobility. The masses of the people are prevented by economic and social conditions from entering these occupations in any considerable numbers and so the earnings remain high. Wages also are high when the numbers in an occupation are artificially restricted by combination among workers.

Prudent men when choosing occupations for themselves or for their children should look not only at money wages, but also at other advantages and disadvantages of different occupations.

tions—they should attach a proper degree of importance to the expenses of training for the occupations, regularity of employment in it, chances of success, whether the work is agreeable, healthy, safe, supplementary earnings and also social advantages. When occupations, otherwise suitable and profitable, are rejected only on grounds of sentiment and social prejudice by a man choosing an occupation for his son, the son is injured economically and the nation also suffers. If the occupation of a lawyer is chosen for their wards by many fathers on grounds of social prestige, the profession is overstocked, the earnings are low on an average for the members ; and there is a great loss to the nation through the wasting of many young men with their abilities and energies frittered away which might have been much better used for themselves and their country in industry and trade.

An evil paradox. *

It had been seen that generally speaking the more disagreeable the occupation, the higher the rate of wages. We have however the evil paradox that *the dirtiness of some occupations is a cause of the lowness of the wages paid in them* and the reason is this: The employer finds that to have his work performed by skilled men with proper appliances he will have to pay a high rate of wages on account of the unpleasant nature of the work. So he has the work done by low-grade labourers, who are not worth much to any employer and who earn very low wages. And the numbers of such labourers are generally large and their mobility is small and thus their wages are kept from rising.

*** Low wages of women.**

“‘Though both (i.e. Adam and Eve)
Not equal, as their sex not equal seemed ;
For contemplation he and valour formed,
For softness she and sweet attractive Grace.”

—Milton, *Paradise Lost*, Bk. IV.

* Mill's treatment of this subject, though old, still retains much of its interest. (*Principles*—Book II.).

Woman is inferior to man—this is the unequivocal opinion of Milton and his generation. The present generation believing in the equality of man and woman in many spheres is naturally interested in the economic question as to why women, in different occupations, generally earn lower wages than men.

The wages of women are generally lower and often very much lower than the wages of men. Women's wages are in many cases insufficient to maintain a woman even if she is alone and they are good enough only as an auxiliary wage to supplement the family income. It has been calculated that in 1912, the average wages for an adult workman in England amounted to £1 5s. 9d. per week, and the average wages for an adult working woman amounted to less than half this sum.

The low wages of women constitute one of the grave social problems of the day.

The causes of low wages of women.

(1) One reason generally advanced is that women are in most cases less productive than men. †But this is not, however, always the case.

(2) It is said that a woman has a lower level of subsistence and fewer needs than a man. Moreover a man has to earn enough wages to maintain himself and his family whereas the wages of a woman go generally to maintain only that woman. These things depress women's wages.

But many women workers have to support not only themselves but also dependents—in England these women workers with dependents to support form about two-thirds of the whole. So the low wages of women cannot be explained adequately in this way. There are other causes.

(3) Women generally occupy non-competing groups relative to men. They are prevented by custom, lack of training, trade unions from entering many skilled occupations in which men earn high wages; and in the occupations which are resorted to by women, excessive competition among themselves brings down the rate of wages.

† Mrs. Fawcett quotes satisfactory evidence which goes to show that at least in many war industries, the allegation about the inferior productivity of women is without foundation. (*Aferwar Problems*).

The low wages of women, even when they are doing the same kind of work as men, or work requiring the same exertion—low wages of women under these conditions are due (a) partly to the lower subsistence level of women, and the fact that some women have no dependents to support and (b) largely to the lack of organization among women workers. Women are badly organized and so are forced to accept lower wages than men.

The conditions favouring a general high level of wages for all classes of workers in any country (C. U. 1933).

A general high level of wages for all classes of workers in any country is possible only as a result of the high productivity of labour in the country.

This high productivity of labour may be brought about by (1) abundant natural resources in the form of very fertile land, very productive mines, forest areas, etc., to which labour is applied.

(2) Ample supplies of capital and banking facilities, high grade employers, and inventors of machinery and processes, making labour more productive and raising wages.

(3) High level of intelligence and education among the labourers, high standard of workmanship which may be brought about by individual as well as collective trade union action on the part of the labourers, free political and social institutions encouraging labourers to do their best and giving free scope to them to rise to high positions of trust, responsibility and leadership in the business world—all these things help to make labourers more productive and to secure labourers of classes a general high level of wages.

THE WAGE SYSTEM.

Advantages and Disadvantages.

ADVANTAGES.

The advocates of the present wage-system maintain that it has the following advantages :

(1) The entrepreneur has full control over the business and this makes for efficient production.

(2) It secures for the labourer a definite and fixed income whether the business turns out a success or a failure.

The French liberal school looks on the wage system as a permanent one and the only improvement it suggests is to make the labour contract, more free and deliberate, and organized on the part of both the labourers and the employers.

DISADVANTAGES.

(A) *Socialistic criticism.*

The socialist school sees in the wage system simply a historical category, the third stage in an evolution of which the first two stages were slavery and serfdom.

The socialists criticise the wages system and point out the following defects :

(a) The dependence of the labourer upon the employer.

(b) The deduction of interest and profits from the product of labour and at the expense of the labourer.

The socialists recommend the abolition of the wages system along with the system of private property.

(B) *Criticism by co-operators.*

The co-operative school also regards the wage system as a temporary one to be replaced by a better system in future. They point out the following real defects characterising the wage system :

(1) The conflict of interests between the employer and the employed, one trying to give the minimum wage for the maximum labour and the other trying to give the minimum labour in exchange for the wage received.

(2) The labourer getting a fixed rate of wages has no incentive to do his best and so the efficiency of production seriously suffers.

The remedy suggested by the co-operators is co-operative production.

SUMMARY.

Wages.

1. The term 'wages' is used in a wide sense to mean the price paid for the services of labour.

2. The '*real wages*' of labour (*i.e.*, the necessities and conveniences of life that are given for labour) are to be distinguished from the '*nominal wages*' of labour (*i.e.*, the quantity of money paid). In calculating real wages, allowance has to be made for variations in the purchasing power of money, trade expenses, certainty of success, regularity of employment, supplementary earnings, varieties in the form of payment, duration of labour power and other things.

3. Theories of wages.

(1) *The theory of the iron law of wages*—wages are determined by the minimum necessary to maintain a labourer and his family. *Objections* (i) This theory cannot explain the inequality of wages in different occupations in the same country, also in different countries or at different times, (ii) it neglects the demand side of labour.

(2) *The residual claimant theory*. The labourer is the residual claimant in distribution and his wages equal the product of industry minus rent, interest and profits determined according to the laws of rent, interest and profits. *Objections*. (i) The theory is inconsistent with the well-known fact that combinations of labour can raise wages, (ii) it neglects the supply side of labour, (iii) and by Walker's own admissions it applies only under certain conditions, and these conditions are rarely if ever realised.

(3) *The Wages-Fund theory*. Wages are paid out of capital. The average rate of wages is determined by dividing the fixed Wages-Fund (circulating capital) by the number of labourers.

Objections: (i) Wages are advanced out of capital, but they are ultimately paid out of the product of industry; and the product of industry can be increased by increasing the productivity of labour and in other ways. (ii) There is no rigidly fixed national wages-fund, and no rigidly fixed individual wages-funds. (iii) An increase in the number of labourers increases the product to be divided.

(4) *Demand and supply theory of wages*. Wages are determined by the demand for and the supply for labour. The equilibrium rate of wages is the rate which equates the demand and the supply.

(5) *Taussig's theory*. Wages are determined by the discounted marginal product of labour.

4. Differences of wages in different employments are due to differences in the efficiency and exertions required in them. Other causes of these differences in wages are (1) agreeableness or disagreeableness of the employment (2) ease or difficulty of learning it, also expense of training (3) regularity or irregularity of employment (4) certainty or uncertainty of success (5) supplementary earnings, and other incidental advantages.

Marshall has pointed out that the dirtiness of some occupations is a cause of the low wages paid in them.

The wages of women are generally much lower than the wages of men. This is due (a) partly to the low productivity of women, (b) partly to their lower subsistence level (c) and also to excessive competition among women in certain occupations.

Questions.

1. What different meanings are given by economists to the word 'wages'? Are the earnings of the entrepreneur for his labour of superintendence 'wages'?

2. Distinguish between 'real wages' and 'nominal wages.' How are we to calculate the 'real wages' of labour in an occupation? (C. U. 1920).

Write explanatory notes on time wages, piece wages and efficiency earnings.

Point out the intimate relation which subsists between wages and efficiency. Is it true to say that poverty causes degradation? (C. U. 1923).

3. In estimating the relative prosperity of labourers in different countries, is it sufficient to compare money wages? (C. U. 1914).

4. Enumerate some peculiarities in the action of the forces of demand and supply with regard to labour. (1910 H).

Discuss any two of the following theories of wages: (a) Subsistence theory (b) Wages-Fund theory (c) Residual claimant theory. (C. U. 1909, 1911, 1920).

5. Explain and briefly examine Lassalle's Iron Law of Wages.

6. Give a short account of the demand and supply theory of wages.

8. "Wages have been described as the discounted product of industry." Bring out the meaning of the phrase and consider whether it is a correct explanation. (C. U. 1915, Hons. 1928).

9. Give briefly the causes of differences of wages in different employments. (1915 H. 1916, 1930).

10. How would you account for the low wages paid to women? (C. U. 1915). Why are the wages of women low compared with the wages of men for the same kinds of work or for work requiring the same exertions? (C. U. 1918).

CHAPTER IV.

LABOUR PROBLEMS.

Trade Unions.

(A Trade Union has been defined as "a continuous association of wage-earners for the purpose of maintaining or improving the conditions of their employment.") (Sidney and Beatrice Webb in History of Trade Unionism.)

We may notice two types of labour organizations:

(1) The *Trade Union* representing a combination of wage-earners in a single trade or two or three closely related trades.

An association of locomotive engineers all engaged in the same trade is a strict trade union.

(2) The *Industrial Union* composed of all kinds of wage-earners in a given industry. A given industry generally includes many trades; all railway workers including locomotive engineers, guards, station staff may form one industrial union for the whole railway industry.

The disadvantages of labour in bargaining and how they are reduced by Trade Unions.

The labourer bargaining individually with his employer suffers from the following disadvantages:

(1) His labour is a perishable commodity. (2) He has little or no reserve funds and so he cannot wait and therefore he will have to accept the terms dictated by the employer. The employer has reserve funds and can wait. (3) The labourer is comparatively immobile and he cannot quickly find the best market for his labour.

The disadvantages of the individual labourer in bargaining are overcome by *collective bargaining* through trade unions. Concerted action on the part of workmen through trade unions lessens to a very considerable extent these disabilities of the workmen. These unions accumulate funds, which enable workmen to hold out and wait in the process of bargaining. They also reduce the immobility of labour, they have information bureaux and competent officers who give the required information to the labourers and enable them to find the best market for their labour and the employer has to deal not with one workman alone but all—and so he comes to feel that the workmen are as needful to him as he to them.

Two aspects of Trade Union activity.

These are (1) the fraternal aspect, (2) the fighting aspect.

(1) Fraternal functions.

As a fraternal organization, the trade union seeks to accomplish some of the ends and objects of the old guilds. It

insures the member against accident or death, it maintains him when he is ill or when he is out of employment and also confers other benefits. The older unions in England give a large number of benefits. They provide *sick, accident, superannuation and funeral benefits* and they also give *out-of-work pay* to any member who needs it through no fault of his own. They hold also meetings and lectures and exert themselves seriously to diffuse education and culture among the members.

(2) Fighting functions.

Highly important are the militant functions of the Trade Union, through which it seeks to promote its industrial power and to increase the earnings of its members. Its activities in this direction can be reduced to two categories: (a) the attempt to standardise conditions of employment and (b) the endeavour to restrict work. The Trade Union tries to secure a standard rate of pay and a normal working day. The attempt to decrease the hours of work is really an attempt to increase the standard rate of pay.

Trade Unions and Wages.

Have trade unions any influence upon the rate of wages in a particular trade, and have they any influence on general wages? This is a question which has led to great difference of opinion and controversy in the history of economic thought.

Half a century ago, the general opinion among economists was that trade unions could have no effect on wages while the trade unionists maintained that a rise in wages was due to the activity of trade unions.

The economists of the present generation hold a view on this subject, considerably different from that of the early economists.

(1) General Wages.

(a) *Trade unions claim that they prevent economic friction from working against the labourer. If in any trade, wages tend to settle below the marginal worth of labour for the time,*

being, the trade unions can at least raise wages up to the marginal productivity of labour, without causing any displacement of labour.

They reduce the disadvantages of labour in bargaining and thus help towards securing fair wages (i.e., the current or market rate determined under the conditions of fair competition).

(b) Again some trade unions increase the efficiency of labour. Strong trade unions have comparatively high standards of diligence, regularity and good workmanship and thus increase the efficiency of labour; *by increasing the marginal productivity of labour in this way, they help to raise wages.*

Any other ways in which trade unions will increase the marginal productivity of labour will tend to raise wages.

The scope as well as the limitations of Trade Union action for raising wages (C. U. 1933).

Broadly economists hold that the *scope* of trade union action as regards raising *general* wages (wages of all or most classes of workers in the different industries of a country) is to be found in the trade unions helping to increase the productivity of labour and thus to increase the national dividend, thus making possible a rise in general wages. The *limitations* of trade union action as regards raising general wages are to be found in their inability to raise wages when they are unable to raise productivity of labour and the national dividend.

Conditions under which Trade Unions may permanently raise general wages.

Prof. Marshall gives the following conditions under which Trade Unions will be able to raise wages permanently.

The power of trade unions to raise general wages by direct means is never great. The trade union by co-operating with general economic forces, which make for an increase of wages may raise wages permanently and under the following conditions :

(1) Trade unions must aim at making business easy and certain (this is already done to some extent by boards of conciliation in certain trades).

(2) The union must aim at raising the standard of life among the workers by fostering habits of sobriety and honesty, independence and self-respect.

(3) They must help as many as possible of the rising generation to acquire industrial skill and to join the higher paid ranks of labour.

(4) They must try to develop the great stores of business power and inventive resources that lie latent among the labouring classes. This would increase the national dividend and would make possible higher wages.

(5) They must also specially be careful to avoid action, by which one class of workers inflicts direct injury on others. (Workers of one class often injure other classes of workers by curtailing the supply of their raw material or by throwing them out of work through a strike in which they are not interested).

Wages in a particular trade

A trade union can raise wages in a particular trade by restricting the supply of workmen in that trade. Limit the supply of workmen in a given trade and the chance is increased for getting higher wages in it. If the union is strong enough to stop the influx of labour into the trade, then it will be able to raise wages, other conditions being favourable.

The conditions under which a trade union can increase wages greatly by artificially restricting the supply of labour in a trade are given by Prof. Marshall.

If the workers in any trade by combining in a strong trade union are able to limit artificially the supply of their labour, they can secure a considerable increase of wages, which will be the greater the more fully the following conditions are satisfied :

(1) That there is no easy alternative method of obtaining the commodity which their trade helps to produce. ↑

(2) That the commodity is such that its price will be raised considerably by a stinting of supply (or in other words, the demand for it is not very elastic).

(3) That their wages form a small proportion of the total expenses of production of the commodity (and so a great rise in wages will not greatly increase the price of the commodity and diminish the demand for it).

(4) And that the other classes of workers and employers are squeezable and are not in a position to increase their share of remuneration by limiting artificially the supply of their labour and capital.

Advantages of Trade Unions.

We may now summarise the advantages of Trade Unions.

(1) Trade Unions help to keep up wages to the marginal worth of labour ; and trade unions help to increase the marginal worth of labour by raising the standards of efficiency and workmanship, and thus bring about a rise in wages.

(2) By their collective bargaining, the trade unions are also able to better the general conditions of labour, to obtain a shorter working day, better sanitary conditions, better treatment, etc.

And the march of reform is made easier for employers when at each step all competitors are kept in line by the activity of the trade unions.

(3) We must also include the benefits resulting from the fraternal activities of the trade unions.

Sick, accident, and super-annuation benefits and the *out-of-work* pay, paid by these unions must be noted ; and the promotion of social intercourse, education and culture and the raising of the standard of life brought about by trade union activity are very important gains.

History of Trade Unionism.

England has taken the lead as regards the trade union movement. The principal object of the original trade unions at the beginning of the 18th century was to secure the better enforcement of various protective laws such as the statute of apprentices.

Trade unions at first were not recognised by the law. In 1824 the repeal of the combination laws made the membership of a trade union cease to be a criminal offence and an Act of 1871 gave trade unions their present status.

The position of Trade Unions has been further strengthened by subsequent legislation.

New and Old Unionism in England.

We must distinguish between the old unionist movement and the new unionism. The old unions discharge two main functions—protective and benevolent. Those that exist primarily for protection against employers resort to strikes when necessary; and those who make the provision of benefits their main concern are more unwilling to resort to strikes, because strikes will reduce their funds for giving benefits.

Many trade unions started in recent years have somewhat different aims and objects from the older trade unions. A new type of unions has sprung up specially in the unskilled trades. The new unionism is more aggressive, more willing to resort to strikes, it generally regards provident funds as an encumbrance leading to an unenterprising and over-cautious policy. And these New Unions favour a larger participation in politics with the object of influencing legislation in favour of the working classes.

English trade unions played a very patriotic part during the War and for the period of the War suspended many of their rules and restrictions.

The latest development in English trade unions is a strong movement towards the policy of 'direct action' (i.e., direct industrial action by general and widespread strikes etc.) for winning their economic and political objects—this being due to the loss of faith in political and parliamentary action for achieving their ends.

The two chief methods of labour organizations are

- (1) *The Strike.*
- (2) *The Boycott.*

These are the methods by which the labour organizations seek to realise their objects.

The Strike.

What is the strike? A strike is a cessation of work resulting from an agreement on the part of a body of workmen, the object being to compel employers to accept the demands of the workmen. *It is thus a method of industrial war, war between the workmen and the employer; and the object is to*

obtain from the employer by force what cannot be obtained otherwise.

The right to strike has been only grudgingly conceded ; and the legality of the strike is now recognised in all modern states.

(A) Evils of strikes.

The strike is a destructive agency and as such it is bound to produce various evils :

(1) The labourers themselves lose their wages on account of the stoppage of the work.

(2) The employers and the capitalists are also injured by the cessation of production brought about by the strike. Their capital and organization remain idle.

(3) Frequent strikes may cause such disturbance to industry and such trouble to the employer that capital may migrate to other countries to find employment there.

(4) The disorganisation caused by frequent strikes may enable foreign competitors to gain a footing in the country.

(5) In most cases, the consuming public is very seriously inconvenienced by the action of the strikers.

This is specially the case with strikes in important public industries like railways, street lighting, water supply in towns, post office etc.

The strike, though an evil and a serious evil in certain respects, is often a necessary evil. It is not always due to the fault of the workmen, it is often due in a large measure to the faults and failings of the masters themselves.

(B) Advantages claimed by the workmen.

The leaders of the working classes claim the following advantages as resulting from strikes :

(1) *Strikes increase the strength of the trade unions* and encourage the members to make sacrifices for the common good.

(2) Through strikes the workmen acquire confidence in themselves and trust in one another : the masters are taught respect for their men and a reasonable fear of them. And in

this way strikes help the workmen to raise their wages to the marginal productivity of labour and to get better conditions of employment and better treatment from the masters.

Strikes and Wages.

When the wages fall below the marginal worth of labour because of economic friction, organization among employers, custom etc., strikes help to raise wages to the marginal productivity of labour.

One successful strike may send wages up in many industries.

Besides the ever present fear of strikes in the minds of the employers acts powerfully in the direction of keeping up wages.

Even an 'unsuccessful' strike is not wholly unsuccessful, it may make employers more moderate, conciliatory and considerate as they recall the anxieties, the struggles and the sacrifices of the conflict.

Conclusion.

Under the present circumstances the strike is the ultimate weapon of the labourers against the employers, and so long as more peaceful methods prove to be inadequate, strikes are unavoidable. All modern states recognise this and so have legalised strikes—strikes are no longer illegal.

In certain circumstances however the strike is so dangerous for public security that its prohibition has been advocated in these particular cases:

(1) First of all there is the case of functionaries and employees of the state.

(2) Then there is the case of certain enterprises (the water supply, the lighting of the streets, the railway service) the interruption of which may be exceedingly harmful to public security and welfare.

Trade Unions and Strikes.

The question has been asked as to whether there is any necessary connection between Trade Unions and Strikes. As²

Walker points out some of the greatest strikes specially in the early history of the labour movement have occurred without the agency of organized Trade Unions, and there have been Trade Unions which have seldom or never resorted to strikes. A recent development consists of *unauthorised strikes* in England and elsewhere, strikes not authorized by the regular trade union organizations.

So it is a mistake to regard the strike as the sole and essential function of the trade union. In the words of a distinguished writer, a wellorganized union wins the day without strikes, as a good general gains victories without battles.

If the Union is a strong one and if its demands are reasonable it will have its demands accepted by the employers, who will respect and fear the Union, and so the Union will not be generally under the necessity of declaring a strike.

In many cases the Trade Unions have, however, to resort to strikes, due either to the unreasonable demands of the workmen or unreasonable opposition on the part of the employers or mutual misunderstanding.

Syndicalism.

Syndicalism has a complete social programme of its own. It wants to organize the conflict of the classes and to obtain *directly* (i.e., without applying to existing governments) all the rights necessary for working classes by means of single strikes or if need be by the *general strike*. The working classes are to achieve their economic salvation by their own action as organized into unions, by what is called '*direct action*' and not by looking to any help from the state or from social reform.

Syndicalism is a mixture of Trade Unionism and Anarchism. From Trade Unionism, Syndicalism has taken the idea that working-class salvation is to be found not in politics (and parliamentary government as at present constituted) but in self-help and self-organisation through Trade Unions the syndicalist state is to be organised largely by occupations, the workmen engaged in the same trade managing the trade for themselves. From anarchism, Syndicalism has got a deep conviction in the ethical value of a revolt. The syndicalists hold that a general strike might bring on the revolution in fewer days than the decades which politics and political agitation require.

This movement is strong in France, in Italy, in the United States where the Syndicalist movement is supported by an organisation known

as the Industrial Workers of the World. Recently it has also got some hold in Britain.

Labour Legislation.

Labour legislation by the state has the same object as trade unions, it wants to standardise the conditions of employment, and to prevent the employers from oppressing labourers by taking advantage of the bargaining weakness of labour.

Labour legislation on behalf of the labourer has assumed three principal forms dealing respectively with—

- (1) the conditions of work
- (2) the conditions of pay
- (3) the effects of employment.

Factory Acts.

These Acts in all modern countries (including England, France, U. S. A., Japan and even India) deal with the abuses in the conditions of employment of labour and try to remove them.

(a) The earliest form of factory legislation was the *prohibition of child labour*. Children below a certain age are not to be allowed to work. (b) The second form of factory legislation is the *regulation of the hours of labour*. The regulation of hours of labour was enforced first as regards children, then was gradually extended to minors, and to women and finally to adult males. (c) *The third form of factory legislation is protection of life, limb and health*. Factory Acts require the fencing in of dangerous machinery, the establishment of proper sanitary conditions in factories and strict regulation of the so-called dangerous trades.

All modern states have factory acts. England is the original home of factory legislation and its example has been followed by all civilised countries.

Arguments against factory legislation.

The economists of an earlier generation opposed factory acts and this opposition brought them into disrepute with

statesmen and men of affairs and also with the working classes. The usual arguments advanced by opponents of factory legislation are given below.

It will be found that these arguments are unsound and do not possess weight.

- (1) It has been said that state interference with industries through Factory Acts reduces output and thus injures society. The reduction in output also diminishes the profits of business men, discourages capital and enterprise, brings about a fall in wages.

Factory Acts diminish output and thus injure business and wage-earners.

In answer to argument (1), it may be urged—

(a) On the whole, Factory Acts have helped to increase output rather than to diminish it and this is due to the increased efficiency of the labouring class, greater intensity of work and better organization.

(b) And even if there was some loss of output it should be borne in the larger interest of the working classes and society as a whole. The increase of output is not and should not be the only end to be kept in sight.

- (2) Some have maintained that labourers are quite able to protect their own interests and the interests of their family and children without any state help in the shape of Factory Acts. (This is contradicted by the plainest facts of experience. In all countries labourers have been found unable to protect themselves without the help afforded by Factory Acts).

Factory Acts unnecessary as the labourer is able to protect himself.

Arguments in favour of factory legislation.

- (1) *Economic considerations.*

(a) A smaller number of hours of work and better conditions of work increase output by leading to greater intensity of work, higher efficiency of the worker and better organization. This is found to be the case by actual experience in different modern states.

Factory Acts help to increase output

(b) To permit child labour below a certain age is to stunt the growth of the child, body and mind. This and improper conditions of work for women will bring about the progressive deterioration of the working population which will seriously injure the industrial future of the country, and so these things must be prevented by suitable legislative measures.

(2) *Political and social considerations.*

In the absence of suitable factory legislation, the factory population will be overworked, ignorant, discontented and so a source of political danger within the state. This may breed revolutions.

They are also necessary in view of important political and social considerations.

(3) *Humanitarian considerations.*

Men and women are kinder now than they used to be in the past.

The moral ideals of the present age demand that the sufferings of fellow men, women and children in factories should be removed. The main force underlying and bringing about the mass of labour legislation all over the civilised world is the religion of humanity which wants to make life happier for all.

Moral considerations demand factory acts for the protection of the working classes.

The progressive deterioration of the working population in body and mind under unhealthy conditions hurts the pride of race and nationality and weakens the military strength of the State against foreign enemies. These arguments have also helped powerfully the sentiment in favour of factory legislation.

† **Agencies for industrial peace.**

The militant movements among labourers in Europe and America, the increasing hostility of employers and employed, and the losses and disturbances to the employers and the employed and to

* Pigou—*Principles and Methods of Industrial Peace; Wealth and Welfare.*

society at large from strikes and lock-outs (which are methods of industrial war) have led economists and other people to consider seriously measures for reducing the causes of the strife between the employers and the employed.

It is well to bear in mind always that *peace-promoting machinery is of small importance compared with a friendly spirit between the employers and the employed.* Without this friendly spirit, everything is useless—"The life is more than meat, and the body than raiment."

The principal measures advocated as remedies for this industrial strife and as agencies for industrial peace are profit-sharing, welfare arrangements, sliding scales, and arbitration (compulsory and voluntary).

The objects of these agencies of industrial peace are (a) to reduce the danger of conflict between the labouring classes on the one hand and the employing and the capitalist classes on the other and (b) to secure settlement of differences between these classes when such conflicts occur.

(1) Collective Bargaining.

The net influence of collective bargaining by trade unions is unquestionably in the direction of the maintenance of industrial peace. Where a powerful Trade Union exists and where the employers frankly recognise the Union, then strikes are not frequent.

Profit-sharing and the system of the sliding scale and other methods of linking the employed to the employers do not aim at providing a remedy for industrial disputes but at anticipating and preventing such disputes.

(2) Profit-sharing.

Profit-sharing attempts not to provide a remedy for industrial disputes but to prevent these disputes in advance by giving to the employees a share of the profit from the business. At present the entire profit goes to the business man ; but if he gives a share of his profit to the workmen in addition to their

wages, then it can be expected that conflicts between labourers and employers would become less frequent; and as a result of this, production would become also more efficient.

At one time, a great deal was expected from profit-sharing. People thought it would solve the labour problem and would bring about general industrial peace but profit-sharing has not proved so very successful as was expected.

Advantages.

The *advantages* claimed in favour of profit-sharing schemes from the standpoint of production are the following:

1. The labourers getting a share of the increased profit resulting from any extra care and interest exercised by them, they are induced to be generally more careful and industrious in their work.

The result is that there is less waste of materials by the workmen: machinery and other apparatus of production are better cared for, labour disputes are fewer because the labourers share to some extent the profits of the business—and in all these different ways the efficiency of production is increased. The increase in efficiency leads to increase in profits, part of which goes to the employers and part to the labourers who have contributed to the increased profits by their extra care and interest.

2. An increase in efficiency results also in another way. The fact that extra profits are shared in by labourers attracts labourers of superior capacity and industry to the profit-sharing concerns, and efficiency in the profit-sharing concerns thus becomes greater than in ordinary businesses.

The difficulties of profit-sharing.

The reasons why profit-sharing has not proved more successful than it is, are the following:

- (1) It is disliked by labour leaders because employers often use it to weaken the Trade Union movement and to make the labourers dependent upon the employers and not upon their own organized activity in Trade Unions.

(2) Profit-sharing sometimes leads men to work beyond their strength and thus ultimately reduces wages.

(3) The amount of profit going to the labourer is not in many cases large, and so the labourers do not take much interest in profit-sharing schemes. And the labourers also suspect the good faith of the employers and whether the profit-sharing is being honestly done.

(4) A fundamental objection is this: The *profit* that is given to the employees is created by increased care, zeal and speed on the part of these workers. So it *should go to the employees as a matter of right, immediately and not at some future time as a favour from the employer*, it should be given to them on pay-day by piece rate or gain-sharing methods, and not at the end of the year as under profit-sharing schemes. If paid immediately, the premium of the employee cannot be lost by unwise management or dishonesty on the part of the employer, and it cannot be lost by the employee's death, discharge or change of employment. The employers also are not satisfied. They often find that the power of dismissal is a more coarse and cruel but a more effective stimulant to efficiency than a bonus to workmen from eventual profits.

†Taussig's conclusion about profit-sharing is this: "*The prospects that profit-sharing will be universally adopted are nil. Even the prospect for widespread is slight.*"

(3) Gain-sharing.

The object that profit-sharing seeks to achieve is better attained by the various other devices collectively known as gain-sharing. *Piece work* is one of the methods of gain-sharing; and there are other methods.

(4) The sliding scale.

Under this system as the price of the product rises above a certain point, wages also go up by the stages agreed on in

* Taussig, *Principles of Economics*, 1926, Vol. II, Chapter 59, page 342 .

advance and as the price of the commodity falls wages fall till they reach the minimum rate of wages previously agreed on.

So the employer as well as the workmen share the gain from an increase in prices and they also share the loss from a fall in prices.

(5) Welfare arrangements.

• Such are schools and libraries in connection with business enterprises ; gardens, play-grounds, club-rooms, good dwellings at moderate rents for the workmen ; mutual aid societies and pension plans aided by the employer and other similar things for promoting the welfare of the working classes. As Prof. Taussig points out these welfare arrangements are "good not as solutions of the fundamental problems but as mitigations of existing evils."

(6) Arbitration.

Arbitration is a remedy for industrial disputes, when such disputes have occurred.*

Arbitration may be (a) *public* or (b) *private*. Again arbitration may be *voluntary* or *compulsory*.

Some questions (e.g., the recognition of the Trade Union by the employers, the question of the closed shop) cannot be settled by arbitration but must be fought out between the employers and their labourers. *Matters less fundamental* (wages, hours, shop conditions etc.) *also give rise to disputes between masters and men ; and these disputes can be settled by arbitration* through private boards or through public boards.

Permanent private boards of arbitration are based on trade agreements between employers' organizations and labourers' organizations and they are a result of collective bargaining. *Public boards of arbitration* as established in France, in England and also in the United States reduce considerably the number of industrial disputes. *They are commonly boards of conciliation* offering their services as mediators and conciliators and *also boards of arbitration* acting as tribunals to which the disputants can refer.

Compulsory Arbitration.

The question of compulsory arbitration is a complicated one. *Compulsory arbitration* involves the prohibition of strikes and lock-outs and a *compulsory reference to the decision of a majority of a wages board or to the decision of a judge or an arbitrator.*

(A) *Difficulties about compulsory arbitration.* The difficulties as regards compulsory arbitration are the following :

(1) The difficulty about the enforcement of the decisions given by the arbitrators if these are resisted by the labouring class or by the employer class.

(2) Under compulsory arbitration, wages (and practically also interest and profits) will compulsorily be determined by a public authority, and not by competition.

Compulsory arbitration supplants competition and does not confine itself to regulating the limits within which competition shall work. *It is faced with the fundamental difficulty of determining what is fundamentally just in distribution.*

(3) And as †Prof. Chapman points out, in a large industrial community wages under the system of compulsory arbitration may be for a long time thrown out of relation to the relative demands for different kinds of labour in different trades, and *so the response of production to demand would be weakened.*

So compulsory arbitration cannot be applied to all the industries of the nation in many countries, at least under present conditions.

(B) *Compulsory arbitration wanted in certain special industries.*

(i) Compulsory arbitration is however required as regards *fundamental industries*, like Railways, upon the regular and continued activity of which the whole community is dependent.

(ii) It is also wanted in the *sweated trades* where the conditions are absolutely miserable, and the labourers are unable to improve their lot by their own efforts.

* Chapman, *Outlines of Economics*, 1929, Chapter xxviii, page 351.

Unemployment.

The problem of unemployment is a difficult one.

Unemployment means here *unemployment among the wage-earning classes and in respect of wage-work*—It has been described as 'involuntary' idleness† of persons who have no work and of persons who are working short-time.

Socialists like Marx and Rodbertus contend that a large reserve of unemployed workmen necessarily comes into being under the capitalist system ; and they attempt to prove that continuous unemployment on a large scale is inevitable under present conditions.

Evils of unemployment.

The principal evils are (i) loss of wages to the labourers, also fluctuations in their earnings, the sense of insecurity and uncertainty (ii) the habit of regular work may be lost and self-respect and self-confidence destroyed, so that the man once unemployed, may be found to have become unemployable.

The causes of unemployment.

I. Internal causes—*defects in the unemployed* workmen.* These are physical, mental and moral deficiencies of the labourers causing their unemployment.

II. External causes.

The external causes of unemployment are (1) business cycle movements, (2) changes in the conditions and organisation of industry, (3) seasonal demand, (4) the system of casual labour.

(1) Business cycle movements.

It is stated that periods of bad trade follow periods of good trade in cyclical movements after more or less regular intervals. When business is dull and stagnant, when the demand for commodities is slack, employment is not available for all labourers in the community.

† Pigon—*Unemployment.*

(2) *Industrial changes* which are neither cyclical nor seasonal. These changes may be (a) changes in the methods of production or (b) changes in demand and they affect employment.

(3) *Seasonal demand.*

This varies with different seasons of the year. Take the case of the coal miners—in U. S. A. or England, they are least in demand in the summer and at that time many of them will be unemployed. Again persons engaged in the building trade get full employment not in all seasons, but in certain seasons.

(4) *The system of casual labour.*

The casual labour system means employing workmen temporarily for special jobs (instead of giving them regular and continuous work).

The result is that many more labourers are attracted into the occupation than can be regularly employed, and so there is unemployment. (In many countries casual labour is largely employed in loading and unloading freight from vessels and railways).

Remedies.

The following remedies have been suggested for reducing unemployment :

(i) *The labour exchange as a remedy.*

There may be at the same time unemployed labourers, and a demand for just the kind of labour that is unemployed. This labour and the demand for labour can be brought together by labour exchanges.

The labour exchange can be used to provide more regular work for the labourers and thus to reduce the evils of casual labour.

Labour exchanges are most efficient when they are organised into a national system, and when they act not merely as bureaus of information but as centres where the labourers can be actually engaged.

(ii) *Remedy for unemployment caused by trade fluctuation—government action.*

One remedy is to make the public demand for labour compensatory as far as possible.

* A substantial portion of the demand of the public authorities for labour can be made perhaps to vary in inverse relation to the trade cycle, without serious economic or other disadvantages ; the public demand for labour can be increased when there is unemployment and *vice versa*.

(iii) *Other remedies.*

(a) One is the system of spreading the diminished demand for labour over all labourers in the trades concerned—so that all workmen should earn less wages per week than usual rather than some should earn nothing at all.

This is only a *palliative*, and it will not abolish unemployment.

The relief of the unemployed. Insurance.

When unemployment has actually occurred, the distress caused by it may be reduced in the following ways :

(1) The State (central government, also municipalities and local bodies) may provide work for the unemployed to relieve distress—this is done in every country, and in India on a very large scale during times of famine.

(2) Another most important thing is insurance. It has been proposed to organize insurance against unemployment specially through trade unions and under certain circumstances subsidised by the state.

The World Economic Depression and Unemployment.

The World Economic Survey 1932, published by the League of Nations, estimates that at the end of 1931, 20 to 25 millions were unemployed and as a result 60 to 70 million persons mainly in the highly developed and richer countries of the

† So far as the public authorities' demand for labour fluctuates, it is desirable to liberate such demand from the influences of good and bad trade and seasonality, and then deliberately to attempt to make it vary inversely with the demand in the open market. (*Report of the Poor, Law Commission, 1905-1909*).

world were "deprived of the means of existence arising from their own activity or that of those on whom they are dependent." Soviet Russia is practically the only country without a serious unemployment problem.

Causes :

- Refer to pages in the last chapter of the book.

Remedies :

For unemployment on such a world-wide and unprecedented scale, remedies are hard to find.

(1) A chief remedy for unemployment is to employ the unemployed. The hours of work for labourers may be reduced so that labourers will be working less hours than they are working now, but practically all employable labourers will be employed in every country. Children may be kept in school for more years than now and thus get better education ; and, at the same time, this will check to a certain extent the inflow of boys and girls of immature age into the ranks of labour.

(2) Some check to invention of machinery displacing labour and swelling the ranks of the unemployed may become necessary specially in capitalist countries.

(3) Unemployed insurance and allowances in operation in different countries reduce the hardships of the unemployed, but do not remedy unemployment.

Poverty and Poor Law.

A great amount of poverty exists in every modern society.

The causes of poverty are as complex as civilisation and the growth of wealth itself. "The Malthusian seizes upon redundant population, the communist upon private property, the socialist upon property in means of production, the single taxer upon property in land, the co-operator upon competition and so on. They all forget that widespread poverty has existed in the absence of each one of these alleged causes." (*Seligman*).

In the countries of the modern world, the relief of poverty has taken the forms of private as well as public relief.

The Right to Public Relief.

There are three possible reasons why people do not work.

(1) They may not have the physical capacity to work. This is the case with children, the aged and all who suffer from chronic disease or

permanent infirmity. (2) They may not have the means to work, they may not have the materials or implements required. (3) They may not have the desire to work. (1) Now society has to make provision for the first class for reasons of social solidarity. Civilised society considers it a duty to save helpless children and the aged from starvation. (2) Society takes care of the second class for it is in a measure responsible for misfortune. Modern economic progress causes unemployment and crises; and it is but just that society which benefits by this progress should make provision for those who suffer by unemployment and crises. (3) The third class consists of drunkards, and criminal elements. If uncared for, they would commit crimes and would have to be maintained in jails at the expense of society. And the state would find it more economical and prudent to take care of these from the first and thus to reduce crimes instead of simply punishing them.

Economists argue on these grounds for the granting of public relief to persons who have not the physical capacity to work, those who have not the means to work and those who will not work.

The dangers of poor relief.

The classical economists and prominent among them Malthus have emphatically pointed out the dangers of poor relief. They hold "the number of paupers tends to increase in direct ratio to the help they may count upon." And this danger is particularly to be feared when the aid is given by the state. The reasons they give are the following :

(1) The right to relief tends to develop improvidence among the population receiving relief. (2) The right to relief causes a rapid increase of population among the pauper classes. (3) Relief tends to impoverish the productive classes of the society for the benefit of the pauper classes.

But these arguments are useful and serviceable only so far as they make us recognise that poor relief should be carefully organized, otherwise it may produce serious evils. It has been found by actual experience in England and in other countries that poor relief properly administered does not tend to develop improvidence, does not bring about a rapid increase in the pauper population and does not unduly burden the productive classes of the society. And so for reasons of social solidarity the right to relief must be granted.

The Right to Public Relief.

All the different plans for improving the condition of the labouring classes (e.g. trade unions, profit sharing, gain sharing and welfare arrangements, labour laws etc.) will yet leave untouched certain cases of misfortune, improvidence and social wreckage. And it is the duty of the state to care for these cases by giving them relief from the public funds. *Modern conceptions of social duty demand this from the state.*

In the granting of public relief, care should be taken that public charity does not run the risk of demoralising the character of the recipient of the charity.

(1) The state can relieve the pauper, the insane, the blind, the crippled without any danger of degrading their character.

(2) The same thing is true as regards the care of orphans and neglected children by the state. Good care taken of them may make them better men and women and better citizens of the future.

(3) Old age pensions under safe-guards can also be granted by the state without unduly undermining the thrift and the self-respect of the recipients.

(4) The great difficulty is in connection with the able-bodied adults. The general principle in this connection should be—*relief should be made effective but not unduly attractive. If it is made unduly attractive then labourers will leave independent work and will depend more and more upon public charity and thus will be demoralised.*

The English poor law investigators of 1832-34 decided that relief effective but not unduly attractive can be given by enforcing the work-house test, administering poor relief to the able-bodied in the work-houses, where they are made to work under comparatively unattractive conditions, and by abolishing outdoor relief (relief outside the work-houses).

(Modern experience shows that in certain cases and for persons in temporary difficulties, out-door relief is however a more suitable remedy than indoor relief in the workhouse).

History of the English Poor Law.

The history of the English poor law furnishes instructive lessons as to the principles which should regulate poor relief by the state.

First Period (1601—1782).

The permanent pauper system of England was created by an Act passed in 1601 during the reign of Elizabeth. This Act gave every person in the kingdom a legal right to public relief if required; and it followed the correct principle of not making relief unduly attractive, it compelled the able-bodied poor to work, and the funds for granting relief were to be raised by taxation.

Though the principle was strict, a period of somewhat lax administration brought about evils. So by the middle of the seventeenth century and also towards its end, laws had to be passed by which the administration was made more strict and workhouses were constructed.

On the whole however it can be maintained that the spirit underlying the administration of the poor law was strict and severe. *Despite some unnecessary harshness the effect on the working classes was wholesome for it was made undesirable to become a pauper.*

Second Period (1782—1834).

The wise severity of the first period was not properly appreciated at a later stage, and there was a *reaction against the former strictness*. A number of Acts passed during the reign of George III indicated the new lenient spirit. Gilbert's Act passed in 1782 *abolished the workhouse test*, and this Act also provided that the *poor law guardians were to find work for labourers* who could not find work, and help was to be given them to supplement their wages when necessary.

The results of the leniency were disastrous. The large allowance for each child led to a great increase in the pauper population; and the larger allowance for each illegitimate child degraded the morals of the people, and almost abolished female chastity among the English labouring classes. Pauperism enormously increased.

Pauperism enormously increased because (1) under the poor law, the pauper was better provided than the honest, industrious labourer who tried to be self-supporting, and (2) there was a comparatively large allowance for each pauper child. *Immorality was encouraged*, the allowance for an illegitimate child being greater than that for a legitimate child. And the productive classes, the thrifty, honest and industrious were heavily taxed to support an increasing pauper population, indolent, thriftless and dissolute. The amount spent in the relief and maintenance of the poor rose to enormous, and even ruinous sums.

Third Period (1834).

These serious evils made people realise the urgent necessity for poor law reform. And so the Poor Law Amendment Act of 1834 was passed. *This Act restored the strictness of the principle of the Elizabethan Act of 1701*. It re-established the salutary principle of making the position of the pauper undesirable, and thus stimulating him to achieve self-support; and with this object it *restored the workhouse test* making able-bodied labourers work in work-houses.

The Act abolished allowances in aid of wages, discouraged illegitimacy by punishing the father, and facilitated the migration of labourers by modifying the law of settlement.

The effects of the New Poor Law were marvellous, and the burden of pauperism was greatly reduced within a short time.

The Moral.

The moral of this history of the English Poor Law is plain and simple. *"It should be the prime object of legislation to make the situation of the pauper less agreeable than that of the independent labourer, and that by no small interval."* (Walker).

The humaner spirit of the 19th century and after led to discontent with the existing Poor Law, and a new Poor Law Commission was appointed in 1905.

The Poor Law Commission (1905—1909).

The Report of the Poor Law Commission of 1834 was quickly carried into effect in the law of the country. Very different has been the fate of the Poor Law Commission appointed in 1905 and submitting Reports in 1909. There are two documents—the Majority Report signed by eighteen members, and the Minority Report signed by four members and advocating socialistic views.

The Majority Report summarises what it considers to be the main principles of a reformed poor law, *viz.* (1) that treatment of the poor should be adapted to the needs of the individual and there should be proper classification; (2) that there should be fuller co-operation between the poor law authorities and local and private charities; (3) that the system of public assistance should include processes of help which would be preventive, curative and restorative; (4) that instincts of self-respect and self-maintenance should be fostered in every way.

The principle of curative and restorative treatment of the individual is said to be a discovery of this Commission, in fact it is much older and it is all due to the growing humanitarianism and democratic spirit of the age. The poor should not only be maintained, but every effort should be made to restore the sick and suffering poor as far as possible to the full stature of their manhood, physical, intellectual and moral.

(The Old Age Pensions Act of 1908 for the aged poor, the Labour Exchanges Act of 1909 for the unemployed and the Insurance Act have dealt with different aspects of this poverty problem in England and much valuable experience has been gained).

India and Poor Law.

The Indian government practically accepts the duty of supporting the poor in the case of (a) European vagrants, (b) lunatics, (c) and children with criminal tendencies. In India (unlike Britain) the government does not accept the duty of supporting the poor as regards the general population (except in times of famine)—India has no Poor Law, and the relief of the poor is generally by private charity often indiscriminate, generally unorganised but full of that kindly human sympathy so characteristic of the Indian people.

Labour legislation, minimum wage and social insurance.

Of recent labour legislation in the more progressive countries like Germany, the United Kingdom and the United States, etc. the following

deserve special notice and are indeed of high significance for the industrial welfare of nations :

- (1) The Minimum Wage.
- (2) Provision against accidents.
- (3) Provision against sickness.
- (4) Provision against old age.
- (5) Provision against unemployment.

The impelling forces bringing about these much-needed changes are the following: (a) The labourers are better educated, better organised and politically much more influential than before, and they are demanding better standards of living—they want to live the lives of human beings, and not mere down-trodden beasts. (b) Society is realising that the labourers' hardships in sickness, old age and unemployment etc. are due more to social causes than to individual sins and failings of the labourers—due to general industrial and political conditions which too often deny facilities for adequate training and equal opportunity to large masses of the people. Widespread humanitarian feeling has helped the good cause.

Minimum wage.

Minimum-wage legislation was first introduced in Australasia—the home of much fruitful labour legislation. In 1909 it was introduced in England and for four occupations—the ready-made and wholesale-bespoke tailoring, machine-made lace and net finishing, paper-box making and making of certain sorts of chains; in 1912 it was extended to coal mines in England and Wales. A great extension of minimum-wage legislation is expected in all progressive countries—and in the near future.

Principle.

The principle is clear. And it is salutary. Labourers are justly protected by legislation against accidents, against unhealthy hours and conditions of work; and it is equally reasonable that they should be protected against a lowering of wages which would damage their health and physical and mental efficiency.

Advantages.

The limited experience of minimum wage legislation is almost wholly in its favour. (1) It has encouraged the poorest and the weakest labourers to organise and form trade and labour unions. (2) It has raised somewhat the wages of the poorest class of labourers. (3) The increased wages have come partly from increased efficiency and productivity of labour, partly from a decrease in profit and partly from an increase in price. And this is almost wholly desirable.

Prof. Tamasig maintains "As with legislation on hours, factory conditions, and the like, a compulsory minimum wages rate might serve simply to regulate the plane of competition. All employers would be affected alike; There would be obvious difficulties of administration, attempts at evasion But they involve no new questions of principle."

Accident, Sickness, Old Age, Unemployment.

Professional economists have come to realise with the increasing pressure of public opinion that provision for the labouring class is necessary—in cases of accident, sickness, old age and unemployment. They, however, profess to apply a test how far help can be provided for the labourers without demoralising and weakening their character and without destroying the thrift of the individual.

It is generally recognised that injuries from accident cannot be feigned. So here is no chance of demoralisation from help given.

Illness can be feigned. It can be detected too with suitable safeguards, adequate statistics and records, and an efficient organisation, and its evils minimised. The social gain from adequate help given to sick labourers largely outweighs all possible evils and losses.

Old age cannot be feigned. And so no risk of demoralisation. Vast numbers of labourers—the vast majority of them—make no proper provision for old age. And so no risk of undermining thrift by aid given. Old age pensions in a country may be (i) on a contributory basis, with contributions from each worker, or (ii) on a non-contributory basis. The second system is simpler, but more expensive for the government—and has been adopted in Britain.

Unemployment is a serious problem—is to a certain extent inevitable under the existing conditions of capitalism and private enterprise. A main point of the socialist attack against the present system relates to this unemployment problem and the grave injuries which millions of workers in modern countries suffer because of unemployment. The causes of unemployment and some of the remedies have been discussed in pages 377-379. Here we have to consider insurance against unemployment. Prof. Taussig voices the opinion of professional economists generally when he asserts about unemployment insurance that "the irregularities are of a sort which do not tend to offset each other, like the chances of death and old age That they vary from occupation to occupation is not so serious a difficulty. Insurance against unemployment would doubtless have to be organised, like insurance against accident, on the basis of occupations and with differences of rates according to the varying risk of unemployment. *All such difficulties are however slight in comparison with the fundamental one; how to prevent an unemployment benefit from demoralising the recipient . . . For most men, assured support until a job is found makes it too probable that the job will not be sought.*"⁴

The Ghent system—adopted by some Belgian cities, also in Norway—provides unemployment insurance by utilising the trade union machinery. Trade unions in Britain and certain other countries offer unemployment benefit to their members; and the members of the local union know full well the state of employment in the locality, and the character of the unemployed member—and so fraud is almost impossible. If the government supplements the trade union unemployment benefit, the money will be well spent and the risk of fraud will be reduced to a minimum.

Germany. Britain. France. United States.

In this great movement for the amelioration of labour—labour insurance—Germany has been the pioneer. Britain also has not lagged behind. And so far the least progress has been made in the United States.

Accident insurance is of two sorts: (1) *compulsory insurance* as established in 1884 in Germany where the employers are required to organise directly in insurance associations of their own, efficiently supervised by the government; (2) *voluntary insurance* as established by the Workmen's Compensation Act in 1897 in England which imposes on the employers liability to pay pensions on the disability and death of employees through accident, against which liability they can insure themselves in existing insurance companies doing this kind of business. It is desirable that compensation should be adequate, certain—and as in Britain available in all industries.

In insurance against sickness—health insurance—Germany has led the way. The first law on the subject was the German law of 1883; and substantial progress is indicated by the National Insurance Law of 1911 in Britain. In Germany and Britain insurance is compulsory; there is strict state control; there is no state insurance fund. In Germany the employer pays one-third and the employee two-thirds of the insurance premiums; in Britain the state makes a contribution. Health insurance in the United States is voluntary; but accident insurance is compulsory.

As regards insurance against old age. In 1889 Germany adopted a national system of compulsory old age insurance. France followed in 1910. In France and Germany the insurance premiums are paid half by the employer and half by the employee. Another system is that of non-contributory old age pensions, the entire expenses being borne by the government of the country. Britain introduced this system in 1908 following the example of Denmark and the Australian states. In Britain and Germany the pensions begin at 70, in France at 60 years of age. In the United States, the subject is arousing interest. Not much, however, has yet been done.

In unemployment insurance, the lead still remains with Great Britain. "With this enormously difficult problem Great Britain

grappled courageously, 'almost adventurously', in her insurance act of 1911. This great measure provided not only for 'an all-embracing system of insurance against sickness and permanent infirmity, but also for a large though not universal one against unemployment. Thereby Great Britain came to provide, like Germany, for sickness and disability, as well as for accident and old age; and in this humane rivalry took the lead by providing for unemployment also. In certain important occupations (such, for example, as building, the so-called engineering trades, ship-building) insurance against being out of work was made compulsory. Contributions were required in equal amounts from employers and employees, the state also adding a share."

Co-operation.

Co-operation in production, consumption, credit etc.

Co-operation has been called the one successful social experiment of the nineteenth century. In the different spheres of production, consumption, credit, co-operation is doing an immense amount of good to promote the true welfare of the masses and its future is full of the highest promise for the progress of the working classes.

Co-operation has been tried in retail trade, in credit and banking operations and in production.

For different kinds of co-operation see Part I, pages 326-330.

(1) Consumers' co-operation or co-operative purchase (Co-operative Stores).

Co-operation in retail trade (sometimes called distributive co-operation) or the co-operative purchase of commodities is the simplest and most successful kind of co-operation. Consumers of commodities combine to purchase what they need. They form a company, employ a manager and clerks, subscribe for shares, and this company purchases the commodities and then it sells them to its members. In this way, the shop-keeper is eliminated, the consumers become in effect their own shop-keeper.

These associations of consumers for co-operative purchase are also called co-operative stores. In this kind of co-operation England has taken the lead.

Advantages.

The advantages are very considerable. (1) The shopkeeper being eliminated, his *profit goes to the consumers*. (The consumers' association gets goods at wholesale prices and sells at retail market prices and thus it makes a profit, this profit goes to the consumers partly as interest on their capital and partly in proportion to their purchases).

• The profit is paid at stated intervals and this accumulation of profit for sometime makes it considerable and increases its chance of being saved. The co-operative stores thus make savings and also *act as savings banks*.

(3) The consumers are their own shop-keepers and so the association *does not lose money through bad debts*.

(4) The consumers naturally take care that their own shop supplies *goods to them of the proper quality* and not adulterated and injurious articles. Also *less expense has to be incurred for advertising*.

Some part of the profit is spent for educational and other welfare purposes.

In England and Scotland, distributive co-operation or consumer's co-operation has met with very great success. On the continent of Europe also there has been a considerable development of distributive co-operation. In the United States, the conditions are different and so distributive co-operation has not attained the same sort of growth and importance in that country.

* (II) Co-operative Credit Societies* (Co-operative Banks).

In co-operation for securing better credit facilities, the Germans have taken the lead; and the names of Schulze

* The two types of co-operative credit societies—The Schulze-Delitzsch type of co-operative bank for towns and the Raiffeisen type of co-operative bank for villages in Germany.

(I) The Schulze-Delitzsch Model.

"The Schulze-Delitzsch credit bank is an association created to provide credit facilities for its members only. The necessary funds are

Delitzsch and Raiffeisen will be ever memorable in this connection.

The essence of co-operative credit consists in co-operation as regards credit i.e., co-operation in borrowing and lending. Each farmer borrowing on his own individual security will have to

raised by two means, one material and the other immaterial, share capital and unlimited liability. Each member must subscribe one share, and, where, as is usually the case, liability is unlimited, one share only.

The actual sum varies from Society to Society, but the minimum is about £6.

The profits of the Society are distributed in two parts: One part to the reserve fund and the remainder to the shareholders, according to the size of their shares. *The reserve fund*, which is obligatory by law, usually amounts to about 20 per cent. of the share capital. The entrance fees of members, which are of small amount, are added to the reserve fund. It is customary to devote all the profits of the first year or two to the reserve fund and afterwards 15 to 20 per cent.

Shares and reserve fund, together with unlimited liability, where this occurs, constitute the secure basis on which further supplies of capital are obtainable. These are (a) deposits, (b) re-discounts by an outside bank.

Schulze-Delitzsch was probably right in insisting on the importance of a self-owned and well-remunerated capital for an industrial bank, especially in view of its value as a stimulus to thrift; and the resultant danger of "Capitalism" is less than has been imagined. In all banks the borrowers must be shareholders; in nearly all banks i.e., in banks with unlimited liability, none can hold more than one share, and this share can always be paid by instalments.

Now it cannot be claimed that the societies as a whole sacrifice their reserve fund to their dividends.

(II) The Raiffeisen Model.

The Raiffeisen bank is the Schulze-Delitzsch bank applied to the country (i.e., rural parts), with the variations required and justified by the difference of environment.

The model rules of the Raiffeisen Societies state that "the object of the Society is to improve the situation of its members both materially and morally, to take the necessary steps for the same, to obtain through the common guarantee the necessary capital for granting loans to members for the development of their business and their household, and to bring idle capital into productive use, for which purpose a savings bank will be attached to the Society." One word in the above, viz., "morally," intimates at the outset a distinctive trait.

The subscribed capital of the bank is practically nil; there is nothing but the universal unlimited liability of the associated members. Schulze-Delitzsch, dealing with industrialists subject to unseen risks, who operated in trade matters out of sight and control of the Society, obliged his associates to subscribe a considerable share capital not only

pay a high rate of interest and will not in many cases be able to get a lender having sufficient confidence in him to lend him money; in co-operative credit, the farmers borrow on their joint security, which is stronger than individual security, and therefore they are able to borrow at a low rate of interest. The capital that is borrowed on the joint security of members is then lent to the members at a slightly higher rate of interest, and in this way the members are enabled by the system of co-operative credit to get loans at a rate lower than they would

as a proof of thrift, but as a material guarantee for their individual and corporate debts. Raiffeisen, dealing with agriculturists and villagers, demanded no such security, since each member possessed in his little farm, his cattle or implements, material guarantees far beyond those of any subscribed share.

Because Raiffeisen wished to create credit among small agriculturists out of the immaterial asset of mutual knowledge, he limited the size of each society to a single village.

All profits remain the collective property of the Society, to be used for the Society's good. In actual figures, the reserve funds are not so strong as in the town bank, owing in part to the lower loan charges.

The willingness with which peasants bring their savings to the bank is a triumphant proof of Raiffeisen's contention that the small agriculturists by a combination of unlimited liability and close supervision can become absolutely creditworthy. No savings since the foundation of the first village bank have ever been lost through bankruptcy.

The member of the Raiffeisen bank, though he have the best of pledges, is rejected unless he is known in his private life to be virtuous and industrious. Further more *the society requires to know not only the character of the borrower, but also the specific object for which his loan is destined.*

A Raiffeisen bank is never what a Schulze-Delitzsch bank sometimes is; a handsome building with barred windows, within which are a number of clerks discharging a constant round of business, while the directors interview the special clients in a room apart.

It (the Raiffeisen Society) is a small single room, probably at the back of a farm building, opened twice a week and presided over by a single occupant—the accountant (Rechner). Business is apt to proceed desultorily; a small child brings in a few savings, an hour afterwards a palsied old man, signing by a cross, draws out a couple of pounds, and so on till the end of the day. But this is the unimportant part of the business. The really important part is the weekly meeting of the directors, half a dozen in number, who meet to discuss the various credit claims which have arisen. They are unpaid, as by the nature of their work they can afford to be. The accountant, their executive clerk who keeps the books, "the soul of the society", as Raiffeisen called him, is the only salaried official." C. B. Fay.—*Co-operation at Home and Abroad.*

get if they borrowed each one of them separately on his own individual credit. This is the essence of co-operative credit.

(a) Co-operative credit societies lend generally to members only and (b) they generally lend on the personal security of the borrowers, not on mortgages or on the security of working capital, etc. and (c) the management is in the hands of the members.

Co-operative credit societies are of many kinds. They may be divided into two principal classes, (a) rural co-operative credit societies chiefly for agriculturists (b) urban co-operative credit societies for the small artisans in towns etc.

(A) Co-operative Credit Societies for agriculture. The

Raiffeisen type. The agriculturist requires capital for current working expenses and he has to borrow capital for this purpose, the period of the loan being longer than that for commercial loans represented by bills of exchange but shorter than that of mortgage loans.

One of the most successful types of co-operative credit societies was founded by Raiffeisen in Germany who started his first agricultural bank in the year 1849.

These co-operative credit societies for agriculture have generally the following features: (1) The members bring *no share capital* and (2) they receive *no dividends* (all profits go to constitute an indivisible fund, which by continually increasing enables the society to reduce its rate of interest on its loans and to make itself less dependent on outside capital). (3) The members have unlimited liability, *they are jointly responsible to the extent of all their goods*. (4) *All offices are unpaid except* sometimes that of the cashier or accountant (5) A member knows intimately the other members and so he can accept unlimited responsibility for them. The principle of unlimited responsibility makes each member scrutinise strictly whether the money borrowed by other members is being properly utilised or is being wasted. *This prevents the unproductive use of loans by members and is of the greatest possible importance in securing the solvency and development of the co-operative society.*

The principal advantages of these co-operative credit societies are the following :

(a) The members get loans for their agricultural operations at a reasonable rate of interest and so they free themselves from the clutches of the grasping money-lenders.

(b) The unproductive use of loans is checked. This will not be done at least to the same extent by a government bank or other credit institutions.

(c) These societies establish a connection between credit and saving, and they encourage thrift and help the accumulation of capital by the members.

(d) The agriculturists freed from the grip of the money-lenders and getting loans on easy terms for their agricultural operations prosper greatly from the economic standpoint ; and they also develop self-respect, thrifty habits, temperance, self-reliance, self-help and the capacity for organization for improving their condition.

These co-operative societies have been immensely successful in Germany, in Italy and they have a great future before them in India.

(B) Urban co-operative credit societies. The Schulze-Delitzsch type.

Credit co-operation rural as well as urban first arose in Germany. We have seen that the most successful type of association for co-operative credit in agriculture was founded by Raiffeisen, a German . and one of the most important types of urban co-operative credit societies was founded by another German Schulze-Delitzsch and it is named after him.

The Schulze-Delitzsch type of society. The characteristic features of these Schulze-Delitzsch societies are: (1) The unlimited liability of the members, which is the essential feature. (2) Societies aim at developing credit, but they also aim at developing thrift and habits of saving among the members. (3) Unlike Raiffeisen societies, they have share capital and (4) members get dividends on their shares and (5) to give high dividends, comparatively high rates of interest are charged to the borrowers.

It will be seen that in Raiffeisen societies profits are not paid and expenses are kept down at a minimum, so that all funds may be made available for lowering the rate of interest to the borrowers. In societies of the Schulze-Delitzsch type, so much attention is not paid to keeping down the rate of interest.

The organisers of these societies in Germany hope to give small industries the means of effectively meeting the competition of large industries, by providing small-scale industries with the capital and equipment which they lack.

In Italy co-operative credit societies founded by M. L. Luzzatti are flourishing greatly, but in France and in England they have not attained a very considerable measure of success.

The advantages from the urban co-operative credit societies are largely similar in character to the advantages from rural co-operative credit societies.

(a) They help members to get loans at reasonable rates for their work.

(b) They check unproductive use of loans.

(c) They encourage thrift and saving.

(d) They help to bring about not only the economic but the moral and social advancement of the members. In these urban societies, however, there is less of the true co-operative spirit, the payment of dividends on shares introduces an element of capitalism into the organization.

III. Co-operative production.

Other sorts of co-operative societies have prospered greatly in Germany—societies for the purchase of materials, for the sale of products, for the purchase and use of machinery too expensive for any one member etc.

In Denmark and some continental countries co-operative efforts among agricultural producers has been strikingly successful in curing bacon and in the packing and shipping of eggs etc.

Co-operation has been least successful in production, specially large-scale production; and co-operation can modify

radically the present social and industrial organization only by achieving success in this line.

The advantages of co-operative production, and the dangers and the difficulties which up to present time have prevented co-operative production from attaining any wide-spread success—these are given in Part I, pages 328-329.

As Prof. Taussig points out "the essential difficulty in the way of Co-operation in production is that it attempts to supersede the business man where he is most needed. . . *Co-operation cannot dispense with these leaders; it would have to enlist them.*"

Then as regards the future of the co-operative movement. There is a great and supremely useful future for Co-operation but the hopes of economic reformers of a generation ago that the Co-operative movement will create a new economic world—these hopes, in the opinion of many modern economists, are not likely to be fulfilled.

Summary.

The disadvantages of the labourers (*viz.*, the perishability of labour, varying degrees of immobility and want of reserve funds), in bargaining are reduced by Trade Unions.

Trade Unions have (a) fighting, (b) and fraternal functions. The Trade Union by its organized action helps to raise wages up to the marginal productivity of labour, and under certain conditions can raise wages greatly in a particular trade by artificially restricting the supply of labour.

The *old unions* generally paid more attention to providing benefits of different kinds, the *new unions* are less concerned about benefits, they are more for strikes and participation in politics. (A recent development in England is the movement for *direct action* by strikes to get fulfilled for the working class their political and economic demands, a section of the workers having lost faith in political agitation and parliamentary action).

The *strike* is a method of industrial war. *Evils.* It is a destructive agency; and causes loss to employers, to capitalists, to labourers through a loss of employment and wages, to consumers, and if too frequent, may inflict permanent injury upon the industries of a country.

Advantages. Defenders of strikes maintain that strikes strengthen the solidarity of the trade union movement, increase the confidence of the workmen in themselves, teach masters to respect their men, and

thus help labour to raise wages and get better conditions of employment.

In most industries, the strike is an evil, but a necessary evil, and has to be tolerated; but in certain vital industries it must be prohibited in the public interest. There is no necessary connection between the trade union and the strike.

The usual arguments against *factory laws* are (i) that they interfere with liberty (ii) that they are unnecessary and the labourers are able to take care of themselves (iii) they diminish output, injure business and bring down wages. The principal arguments for factory laws: (i) moral considerations (ii) economic considerations viz., (a) factory laws on the whole help to increase output (b) and they safeguard the industrial future of the race (iii) considerations of national strength and social welfare.

Industrial war brings about serious evils in its train, and so we require the agencies of industrial peace. Some principal *agencies of industrial peace* are profit-sharing, welfare arrangements, sliding-scale, arbitration (compulsory and voluntary).

Profit-sharing (i) promotes the zeal and efficiency of employees (ii) makes them careful and economical in the use of materials and machinery (iii) and thus increases the total product (iv) and increases the income of the employees who receive wages at the current rates plus a share of the profits. Profit-sharing has its difficulties; and it is disliked by labour leaders and also by some employers who regard the power of dismissal a more effective instrument than profit-sharing.

Arbitration is (i) voluntary or compulsory (ii) public or private. Private boards of arbitration are based on voluntary trade agreements and collective bargaining. Public boards of arbitration are often boards of conciliation as well as boards of arbitration.

Compulsory arbitration has its difficulties, and it should be introduced only in fundamental industries (like railways and other industries upon the continued activity of which the whole community is dependent) and also in sweated industries.

Unemployment. Causes (I) internal viz., physical and moral defects of labourers, (II) external (i) business cycles, (ii) changes in industrial methods etc., (iii) seasonal demand, (iv) casual labour.

Remedies. (a) the labour exchange (b) spreading the diminished demand for labour over all labourers in the affected trades (c) making the public demand for labour compensatory as far as possible.

Poverty and the poor law. The causes of poverty are complex as civilization itself. The right to public relief is based upon modern conceptions of social duty, and the state must take particular care that state charity does not demoralise the recipients of the charity. The greatest difficulty is in connection with the able-bodied poor; and for them relief should not be made too attractive, their position should not be made more desirable than that of the independent labourer.

Co-operation is the most successful social experiment of the 19th century

(a) *Consumers' co-operation* (also called distributive co-operation). *Advantages.* (i) It eliminates the shopkeeper's profit and secures it for the consumer, encourages thrift (ii) prevents adulteration of goods (iii) avoids bad debts (iv) saves much in connection with advertising etc.

(b) *Co-operative credit* had its origin in Germany. Its remarkable progress is one of the hopeful signs of the future. Some important features are (i) loan to members only (ii) personal security for the loans (iii) management by members.

(c) *Co-operative production* has not been so successful as co-operative consumption.

Its advantages. (i) The labourers are their own employers and in addition to wages, get profits (ii) much labour of superintendence is saved, and the energy and industry of workmen are stimulated (iii), strikes are prevented (iv) more continuous employment for labour.

Questions.

1. (a) What are Trade Unions? Give their functions and indicate the methods which they adopt to raise wages. (1910 H. 1922).

Discuss the effects of trade unionism on wages and conditions of labour. (C. U. 1925).

Discuss the scope as well as the limitations of trade union action for raising wages. (C. U. 1933).

To what extent and by what means can trade unions influence (a) the wages paid in a given occupation and (b) the general level of wages. (C. U. Hon. 1928).

Discuss the effect of trade unionism on wages. (C. U. Hon. 1932).

(b) Trace the origin of Trade Unions. Explain the nature of any change which may be noticeable in the aims and objects of Trade Unions in recent years. (1910).

(c) Is there any necessary connection between unions and strikes? (C. U. 1910).

2. When can wages be raised in a trade by an artificial restriction of labour supply? (1912 H. 1920).

Or,

Carefully consider whether labour can raise the level of normal real wages by means of combination. (C. U. 1915).

3. (a) What is a strike? What advantages do labour leaders claim for strikes?

(b) Examine the economic influence of strikes with special reference to their effect on wages. (C. U. 1912).

4. State the arguments for and against factory legislation. (C. U. 1911).

5. What are the principal agencies for industrial peace? Estimate the value and importance of each of these agencies.

Consider some of the more important plans to secure settlement of differences between capital and labour. (C. U. 1911).

Or,

Point out the advantages and the difficulties relating to profit-sharing.

6. Discuss the more important causes of unemployment in the modern industrial world; and examine the efficacy of the remedies usually suggested for it. (H. 1911).

7. (a) What are the duties of the state in relation to the poor?

(b) Trace the development of the present system of poor law administration in England. What were the principles established by the Elizabethan Act of 1601, and how far have these been adhered to or departed from in modern times? (C. U. 1909).

8. Give a short account of different varieties of co-operation *viz.*, (a) co-operative production (b) co-operative consumption (c) co-operative credit, noticing advantages and difficulties relating to each.

CHAPTER V.

Interest.

Definition of interest.

(The payment that is made by the borrower to the lender for the use of capital is called interest.)

Opinions about interest in the past and in the present.

Now the question as to whether interest should be paid is one which has engaged the attention of mankind from earliest antiquity. The law of Moses among the Jews, condemned interest; and the lending of money at interest was also attacked by Aristotle, Plato, two of the greatest names among the Greeks, Cato among the Romans and the Christian Church of the Middle Ages.

The opposition of early and medieval peoples to the payment of interest is easily explained. Money was borrowed in those periods chiefly for the purpose of consumption, the borrowers were poor and in difficulties ; and unable to pay the interest and repay the capital they were often reduced to slavery or to a condition of absolute and hopeless misery.

The position has completely altered now. Now borrowers generally borrow for the purpose of production, they get an income from the capital borrowed by them ; and so the borrowers can without difficulty pay something as interest to the creditor for the use of the capital. Modern opinion therefore does not condemn interest. Even in modern times however many countries have usury laws prohibiting excessive rates of interest on loans specially for consumption.

Theories of interest.

Different explanations of interest have been given. Some of these theories, are briefly described and examined below.

(1) Productivity theories. (Malthus, Say, Carey & others).

According to these theories, interest is a price paid for the productive services of capital. The capital that is borrowed helps to produce wealth and so the borrower pays interest.

Objections.

(a) Productivity theories will not apply to capital borrowed for the purpose of consumption ; they will apply only to capital borrowed for production.

(b) Production with capital produces more good than production without capital—*capital produces more goods but not necessarily more value always.*

Again it has been said that it is not proper to say that capital produces value, rather it is capital that helps to produce other goods and it is the value of these goods that determines the capital value. It is not capital invested in an orchard that gives it value ; if the orchard does not produce anything it may not have any value. It is the goods (fruits) produced by

capital that have value, and the annual production of these fruits will determine the capital value of the orchard.

(2) The use theories. (J. B. Say, Schaffle, Knies, Menger and others).

It is maintained by some writers that the borrower pays interest for the use of the capital as the tenant of a house pays rent for the use of the house.

Objections.

This explanation of interest does not apply to interest on circulating capital, circulating capital is destroyed by a single use. Why should interest continue to be paid when the capital has been destroyed and is no longer in use?

(3) Abstinence theories. (Senior, Cairnes etc.).

According to these theories, interest is the payment made for *abstaining* from unproductive use of wealth.

Objections.

This theory takes into account only the supply side of interest, it maintains that supply of capital depends upon the abstinence exercised by the savers of capital. The abstinence theory neglects the demand side of interest; and on the supply side the explanation is not complete. (See Part I, pages 208-209).

(4) Labour theories.

Interest is paid for the capitalist's labour. (a) In some labour theories, capitalist's labour means the labour of producing capital, (b) and in some other labour theories it refers to the labour of saving wealth.

(5) Exploitation theories. (Marx and Rodbertus).

Interest arises from *exploitation*, from robbing the labourer of part of the total wealth which he produces. The whole value of the product is due to labour, but the labourer gets only a part of the value as wages; and part of the value produced by

the labourer goes to the capitalist as interest, the capitalist thus depriving the labourer of a portion of the wealth produced by him. The leading advocates of the exploitation theory are Karl Marx and Rodbertus. This theory is based upon the fundamental mistake of regarding the whole value of the product as due to labour ; and so it has been rejected by economists.

• * (6) The Austrian theory of interest. •

The Austrian theory of interest, largely associated with the name of Prof. Böhm Bawerk, one of the leaders of the Austrian School, is briefly this :

(i) *The element of time is the cause of all phenomena connected with interest.*

Future goods are always less valuable than present goods.

Future goods are less valuable than present goods when the future goods are uncertain ; and future goods are less valuable than present goods of the same amount even when both are equally certain—and this is because desire which is the source of value is stronger for things near in point of time than for goods far away though equally certain.

The lender charges interest because the present goods given by him at present are more valuable than the same amount of goods to be repaid to him in future.

(ii) Then again the Austrian economists point out the "technical superiority" of future goods or capital in the work of production—this technical superiority of future goods stimulates the demand for capital.

* *The essence of interest, in short, is discount. The capital replaced plus interest is the full equivalent of the capital loaned.*

The loan is a real exchange of present goods against future goods. For reasons I shall give in detail in my second volume present goods invariably possess a greater value than future goods of the same number and kind, and therefore a definite sum of present goods can as a rule only be purchased by a larger sum of future goods. Present goods possess an *agio* in future goods. This *agio* is interest." Böhm Bawerk—*Capital and Interest*. (Bk. III, Ch. IX).

(7) Demand and supply theory of interest.

The theory widely accepted by English and American economists is the demand and supply theory of interest.

The rate of interest depends upon the equilibrium of demand for and supply of capital. *The demand for capital depends upon its productiveness, it depends upon the marginal productivity of capital.* Capital will be used by each producer so long it gives him a nett yield.

Each producer has his own demand for capital and the total demand of all producers gives the total productive demand for capital in the community. We must add to this productive demand the demand for consumption. The aggregate of the productive and consumption demands for capital gives us the total demand for capital in a community.

Then we come to the *supply of capital*. The supply of capital depends upon (a) the customs and traditions of the people with regard to saving (b) their habit of realising the future, (c) the strength of family affection among them, (d) security of life and property, (e) the presence or absence of opportunities for investment of capital, (f) rate of interest.

Some persons would save a certain amount of capital if the rate of interest was *zero*, and indeed even if it was a *negative rate*. Capital would be saved even under these circumstances for the sake of providing for a man's family and for his own self in the future. The capital that would be saved however with a zero rate or a negative rate of interest would be a small amount, insufficient for all the needs of the society.

To induce men to accumulate the large amount of capital required by society, a rate of interest has to be offered.

The rate of interest is determined by the equilibrium of the demand for and the supply of capital. Interest, being the price paid for the use of capital in any market, tends towards such a level that the aggregate demand for capital in that market at that rate of interest, is equal to the aggregate stock forthcoming there at that rate."

Rate of interest	Demand	Supply
5 per cent.	Rs. 20,000,000	Rs. 35,000,000
4½ " "	Rs. 22,000,000	Rs. 30,000,000
4 " "	Rs. 25,000,000	Rs. 25,000,000
3½ " "	Rs. 27,000,000	Rs. 23,000,000

Business men demand capital for industries, etc. (Also there is the demand of spendthrifts and also of governments). As the rate of interest falls, demand for capital increases and supply decreases. In this case 4 p.c. will be the equilibrium rate bringing about an equilibrium of demand and supply—and so will be the market rate of interest.

(8) Interest in relation to marginal productivity and marginal forbearance (C. U. 1933). Tendency of the rate of interest to a minimum.

Seligman's exposition of interest.

In his exposition of the demand and supply theory of interest, Prof. Seligman states "*Interest is the measure of marginal forbearance and it is also the measure of marginal productivity.*" Finally, a point will be reached where these two considerations balance each other, and where we shall be on the margin of doubt whether to save or to spend. Beyond that point we shall surely not save, because we secure more satisfaction from present enjoyment.

When, therefore, we say that interest is the result of forbearance, we really mean that interest is the result of marginal forbearance, or forbearance at the margin the rate of interest depends on the difference between the actual estimate of the present, and that of the future services of the whole mass of capital at the margin, that is, of the marginal increments of the entirety of capital."

He goes on to discuss the tendency of interest to a minimum. "A gradual decrease in the rate of interest is normal as well as beneficial to the community. It lowers cost and enhances prosperity. It would, however, be an error to conclude that this tendency is constant, and that the interest rate will disappear or reach a bare minimum. For, as the rate approaches a certain low point, it sets in motion forces to prevent any further reduction. This can be approached from two points of view.

. . If the rate of interest should conceivably fall so low that the cost of capital might be neglected, it would lead to a well-nigh incalculable multiplication of commodities . . . Putting it in another way, we may

say that after a certain point has been reached any additional decline in the rate of interest will mean a more than proportionate increase in the demand for capital and this augmented demand will prevent any further reduction in the rate . . . So far as experience seems to show, this point means a rate of between 2 per cent. and 3 per cent.

The same result can be reached by approaching the problem from the other side, that of marginal forbearance . . . the rate of interest cannot fall much below 2 per cent. because otherwise the desire to accumulate would be effectually checked.

Taussig's exposition of interest.

For an account, more adequate and satisfactory in some respects, see Taussig's *Principles*, Vol. II, Chapter 39.—“*The rate of interest for long periods—decades at a time—depends on the demand for capital with reference to a supply which is constantly and quasi-automatically increasing. It depends on a race between accumulation and improvement* Hence to repeat, the race is between improvements and accumulations. Given continued improvements calling for more and more elaborate plant—more of time-consuming and round-about applications of labour—then savings can heap up and a return still be secured by the owners of capital. Such has been the course of industrial history for the last century and a half. Such, also, is apparently to be its course at least for another generation or two.”

Rent and interest

(1) Rent is the income from land and other natural resources, interest is the income from capital. They are thus both incomes from material aids to production. Here is an important resemblance. (2) And there are great differences between land and capital. Land is not made by man but is a free gift of nature: capital is produced by man. The amount of land in a country is limited by nature, its supply is inelastic; in the long period the amount of capital is not so limited, its supply can be increased and is increased by the efforts of man.

(3) Again in the short period, there are some resemblances between rent and interest. • The supply of land has no elasticity in the short period as well as in the long period; the supply of capital has also comparatively little elasticity in the short period.

In the long period, this point of resemblance disappears. This is because in the long period, the supply of land remains inelastic while the supply of capital becomes elastic.

(4) It is also pointed out that historically rent increases while the rate of interest tends to fall.

(Prof. Marshall has said *scientifically speaking rent, quasi-rent and interest are three species of the same genus*. He implies that the resemblance between interest in the short period and rent entitles us to regard them, broadly speaking, as belonging to one group of phenomena].

Nett and gross interest.

Nett interest means the earnings of capital when there is no risk of losing the capital and no trouble of management.

Nett interest is also called *pure interest* or *economic interest*.

The interest paid by a perfectly solvent government upon money borrowed by it approaches most closely to this pure interest or nett interest.

What we commonly speak of interest is generally gross interest. Gross interest includes—

(1) Pure interest, (2) insurance against risk and (3) also earnings of management

The greater the risk, the higher will be the gross interest—the risk involved may be the *trade risk* of the particular business for which capital is borrowed or it may be *personal risk* relating to the borrower's personal character or ability. Again of two loans of equal amount that which requires a greater degree of supervision and management must pay a higher rate of interest to the creditor for his greater trouble of management.

So the rates of interest for different investments and for different borrowers vary.

Rate of interest.

It has been already explained as to how the rate of interest is determined by the equilibrium of the demand for and supply of capital.

(A) Different rates of interest in the same market.

We find that there are different rates of interest (gross interest) in the same market. To what causes are we to ascribe these different rates of interest in the same market? The answer is simple. Different rates are due to (1) *differences in the risks and to differences in the trouble of management required.* (2) Again even when the risk and the trouble are the same, there may be *differences in the rates of interest charged in different parts of the same market on account of comparative lack of mobility of capital.*

(B) Different rates in different markets.**Different rates of interest in different countries.**

(a) *All that has been said of differing rates of interest in the same market holds good also of differing rates of interest in different markets. And there are other additional causes.*

(b) *One important cause is the comparative disinclination of capital to migrate to a foreign country. The people of a country will accept a lower rate of interest on capital invested within the country than for capital to be invested in a foreign country. And this disinclination of the people to lend abroad is due (i) partly to the suspicion that foreigners and foreign courts may not be fair to them and their capital, (ii) partly to the danger of war suspending the payment of interest or principal by the foreign country and (iii) also to some extent to the fact that foreign investments must be made generally through an agent whose judgment or whose honesty may not always be all that is desired.*

History of the rate of interest.

The fall in the rate of interest from 5 p.c. to 3 p.c. is one of the striking economic phenomena of the second half of the nineteenth century.

In the post-war period after 1914 there has been a marked rise in the rate of interest and it has been considerably raised by (a) the destruction of vast amounts of capital in the world war (b) the immense demand for capital throughout the world for the purposes of reconstruction after the war.

During the period of the world economic depression (1929—) prices of commodities have fallen much, also profits, wages and interest. Then as regards the future.

Zero rate and negative rate of interest.

Some economists have made forecasts about the movement of the rate of interest in the remote future and they argue that the rate may fall to zero or it may fall below that and the rate of interest may become a negative one. This they expect will happen with a great increase in the supply of capital while the demand for capital will not increase at the same rate because opportunities of its employment are limited in manufactures and transport and because agriculture will become less productive in future on account of diminishing returns. These writers exaggerate the amount of fall in the rate of interest to be expected in future. The accumulation of capital is proceeding at a great rate. The demand for capital though it may not increase as fast as the supply will continue to increase. New fields of industry will be opened up and for them capital will be wanted.

And there must be a rate of interest for inducing men to accumulate a sufficient quantity of capital. If there is no interest many men would not save much and so the supply of capital will be insufficient to meet the demand. Thus we expect the rate of interest will fall in the remote future where there is a large accumulation of capital and comparative diminution in the demand for capital. But there will be a rate of interest to make the supply equal to the demand.

Rate of Interest and the quantity of currency.

We shall consider this question (1) as regards the rate of interest charged by banks for short-period bank loans (2) as regards the rate of interest in general.

(1) If money is plentiful in the money market, then the rate of interest charged by banks will be low ; and if money is scarce, the rate of interest will be high. .

An increase in the volume of *metallic* currency will increase the metallic reserves of banks ; and when the reserve increases, a bank lends more freely to business men and at a low rate of interest. A reduction in the volume of metallic currency in a country brings about a rise in the rate of interest charged by banks on short-period bank loans. So much for the bank rate of interest in the short period.

(2) Then we come to the general rate of interest and the long period. Other things being equal, (a) an increase in the

volume of currency will bring about a fall in the value of money (and a rise in general prices) and (b) a decrease in the volume of currency will bring about a rise in the value of money (and a fall in general prices).

It is maintained by Prof. Irving Fisher that the *rate of interest tends in the long run to accommodate itself more or less closely to the changed value of money and therefore to counteract in part at least the loss caused by changes in the value of the principal of the debt. This is also the opinion of many other economists.*

The rate of interest must change—falling as money appreciates (through a diminution in the volume of currency) and rising as money depreciates (through an increase in the volume of currency).

Regulation of Interest.

Governments in different countries and in different periods of the world's history have attempted to regulate the rate of interest. In historical periods before the era of modern industrial development, loans were generally borrowed by poor persons and for consumption; and government regulation of the rate of interest for their protection was fully justified.

In the modern period, there are also loans to poor persons for consumption; and in such cases government regulation is just and desirable but most loans now-a-days are borrowed by capable business men for productive enterprises (factories, mines, railways, etc.), and the business men generally earn from the borrowed capital more than they pay as interest; and it is the general opinion of the economists that government regulation of the rate of interest in such cases is against the interests of the borrowers and of the community. "The modern theory rests on the conviction that freedom of loans is to the interest of the borrower as well as of the community.

To prevent the lender from securing the market rate is to curtail the offer of capital, to restrict the process of accumulation and to increase the price, open or secret, which the borrower must ultimately pay In the overwhelming majority of instances, modern business loans rest upon

the equality of business opportunity and the free competition of capital. Under such conditions usury laws are futile and worse than futile, because they tend either to evasion or become a drag on industry."

Interest defended. Its social and economic justification.

Like rent and profit, interest has been attacked by socialists as theft, as surplus value, stolen from labour.

Interest has been defended by the orthodox economists—and on social grounds. The vast industrial development in the countries of Western Europe and the United States of America has greatly increased national wealth in these countries, has substantially raised the standard of comfort of many millions of persons; and this industrial development has been made possible by vast accumulation of capital, and this accumulation has been brought about by the stimulus of interest as a reward to those who save. In the words of Taussig "... interest is an inevitable outcome of private property. The whole course of modern industrial development has taken place under that system. We cannot perceive that it could have taken place otherwise.... It must be accepted as part of a system beneficial on the whole, and at all events indispensable; indispensable, that is, in the past and for the visible future."

Mr. Henderson (in his *Supply and Demand*) advocates the necessity of interest not only under the existing system of private property and competition, but also under socialism "As we saw in chapter I, a world socialist commonwealth would require to retain a rate of interest, if only as a matter of book-keeping, in order to choose between the various capital undertakings that were technically possible. And that is the primary function which the rate of interest fulfils in our present-day society. It separates the sheep from the goats. It serves as a screen, by means of which capital projects are sifted, and through which only those are allowed to pass which will benefit the future in a high degree."

Summary.

1. Interest is the remuneration paid for the use of capital.
2. The rate of interest is determined by the relation between the demand for and the supply of capital, and the equilibrium rate is such that it equalises the supply and the demand.
3. Gross interest includes (1) pure or net interest (2) insurance against risk (3) earnings of management.
4. The rate of interest tends to fall as the supply of capital increases faster than the demand for it. The world war destroyed large

amounts of capital and brought about a great rise in the rate of interest.

Different rates of gross interest in the same market are due to differences in risk, in trouble of management, and also to some lack of mobility as between different parts of the same market. One important cause (in addition to other causes) of different rates in different countries is the comparative disinclination of capital to migrate to a foreign country.

Questions.

1. What is interest? Why was the taking of interest condemned in early times, why is it not condemned now?

2. Explain and examine briefly (a) the use theory of interest (b) the abstinence theory (c) exploitation theory (d) the Austrian theory of interest.

3. "It makes really no difference whether we say that interest is the measure of marginal productivity or the measure of marginal forbearance" (Seligman). Explain and comment on this proposition. (C. U. 1933).

4. Give a brief sketch of the complete theory of interest.

5. (a) Distinguish between net interest and gross interest. (C. U. 1921, 1926).

Explain how rates of interest yielded by different investments vary. (C. U. Hon. 1930).

(b) Why are there different rates of interest in different countries? And why are there different rates in the same market?

(c) Examine the causes that determine the rate of net interest at any particular time, and point out the obstacles in the way of the regulation of the rate of interest by legislation. (C. U. 1926).

CHAPTER VI.

PROFITS.

** Profit is the income of the entrepreneur.*

The difference between the total money income which an entrepreneur receives and his expenses of production constitutes

* Prof. Henderson in his *Supply and Demand* gives the current English view as regards the nature and analysis of profits.

General Analysis of profits.

..... Earnings of management, payments for risk-taking and for the special knowledge and advantages associated with it, are

the profit of the entrepreneur. *Profit thus is a surplus above the expenses of production.*

The total profit or gross profit constitutes a composite income, including the following elements:

(1) *The entrepreneur's wages of superintendence.* The entrepreneur often does a certain amount of work, relating to his business, which can be done by salaried managers, and the remuneration which he receives for this is his wages of superintendence.

(2) *The interest on the entrepreneur's own capital* invested by him in the business. The entrepreneur may borrow some capital for his work and he may invest some of his own capital and the interest which he receives on his own capital is another element of his total profit.

(3) *Rent of land owned by the entrepreneur* is another element.

(4) *The entrepreneur is a risk-taker. The function of risk-taking he must assume himself* and it cannot be transferred

ingredients of the gross profits of a business. The chief element that remains is that of interest on capital. Frequently, indeed, it is not the only one. As we saw in the last chapter, a farmer may not be required by his landlord to pay the full economic rent for his farm; and he may therefore make profits above the natural level, above the ordinary return for his own services, his own capital expenditure, and the risks to which he is necessarily exposed. In such a case the farmer is really the recipient, as we have already suggested, of part of the economic rent of the land; and an element of rent accordingly enters into his gross profits. But profits may include a surplus element which may arise in a great variety of other ways. A business may possess some decided advantage which is not open to competitors; and it may reap high profits accordingly For the surplus element arises only in so far as the costs of a business are lower than the marginal costs; and it is the marginal costs which with good reason, we are now endeavouring to analyse. *The marginal costs must include a normal profits i.e., a profit which will cover earnings of management, the reward of risk and enterprise, interest on capital but nothing further.*"

According to the current English theory, profit is a part of marginal cost; and of the price of the product. According to the theory of many American writers, profit is not a part of marginal cost and of the price of the product; it is a surplus above cost, is 'the direct result of price fluctuations' "can last only as long as the economic disharmony or perturbation lasts, that is, as long as the forces are not in equilibrium." See pages 359-360 foot-note.

by him to an employee working for a salary. *And the income of the entrepreneur which comes to him as a risk-taker constitutes the peculiar income of the business man, an income which is never earned by any one except a business man who undertakes risks.*

Risk-taking in this sense requires knowledge and foresight on his part and it involves careful estimates of the amounts of product that can be got from different combinations of labour, capital and land, careful estimates of market conditions and special skill in knowing when to buy and when to sell.

The function of the entrepreneur as a risk-taker can be distinguished from his functions as a manager. The manager's function is to look after the *technical side* of production and to organize the factors of production: the employer's function as a risk-taker is to look after the *value side* of production, to make his use of capital, labour and land most remunerative by knowing when to buy and when to sell and at what prices. Another element of the employer's profit consists in his *gains of bargaining*. The entrepreneur increases profit by outbargaining the other agents of production and paying them less than their marginal productivity, by outbargaining the inventors of new machinery and processes, the consumers, etc.

These two elements of profits *viz.*, (a) the income from risk-taking and (b) the gains from bargaining may be regarded as constituting the *pure profit* of the employer.

(5) Other elements of profit not depending upon the efficiency of the entrepreneur are the following:—

(a) *Monopoly gains* due to a monopoly advantage possessed by an entrepreneur.

(b) *Conjunctural gains* resulting from a favourable conjuncture of circumstances which could not have been foreseen. The farmers of America may make large conjunctural gains of this character in one year through a failure of crops in Europe. The unexpected death of a king by creating unusual demand for mourning goods in the country will give large conjunctural gains to merchants who have already got large stocks of these goods and will be able to sell them at a high price.

So gross profits include many elements and one of these elements consists of pure or net profit; and the theory of net profits may be thus outlined:

Theory of net (pure) profit.

The price of goods in a community must be such as to give to the most inefficient entrepreneurs (whose supply is required by the society), a profit including other items of gross profit [*e.g.*, (1), (2), (3), (5) and excepting pure or net-profit]—otherwise the required supply will not be produced. *The marginal entrepreneur gets no pure or net profits. The entrepreneur more efficient than the marginal entrepreneur gets a differential profit, the amount of the differential depending upon the extent to which the superior entrepreneur exceeds in efficiency the marginal entrepreneur.*

*** A zero rate, of profit.**

Some American economists have held the view that the normal rate of profits is a zero rate. Profit exists in the

* "In a way this gain is self-annihilating. The uniform rate towards which pure profit tends, though it never reaches it in all groups at once,—is a zero rate. . . . Competition tends to annihilate pure profit." —J. B. Clark.

"Profits are the income from business enterprise. They are not necessarily limited to capital. . . . A real estate operator may make profits out of selling lands. . . . It is hence inexact to speak only of the profits of capital.

The best method of gaining an insight into the nature of profits is to consider, first, ordinary profits. By ordinary profits are meant the profits of a regular business that deals in a repetition of analogous transactions in competition with others. The term normal profits is less satisfactory. . . . profits are a result of fluctuations in market value and would not exist in a state of normal equilibrium.

Profits are always a surplus. They are the difference between the cost of production or acquisition and the selling price. They form a differential in a second sense. Profits are the surplus of the intra-marginal over the marginal producer. . . . The excess of price over cost constitutes profits.

It is evident that *in the long run profits could not exist in a state of normal equilibrium* . . . there would be no net profits, or surplus profits, or profits in the real sense of the word. For as soon as a profit appeared the entrepreneurs in other fields who were just making expenses would at once bid against each other in their effort to secure capital and labour, until they would capture their share of the market, and the profits would dissipate themselves on the one hand.

dynamic state, in a condition of progress ; in the static state (in the long run when competition has worked itself out) profit disappears, so in the long run the rate of profit is a zero rate.

English economists are generally of opinion that there must be a *positive rate of profits*; and that normal profit is a part of normal supply price of commodities.

Profit as conceived by the English economists is more in accordance with the usage of businessmen than the other view of profit (held by some American writers) which would associate it with progress in the dynamic state and changes in industrial conditions.

Taussig, an American writer, holds that large profit is earned in the dynamic state and that profit is earned also by the routine conduct of industry. His criticism of the view which would make profit depend solely on the dynamic state is this : "The large and conspicuous gains are in fact associated almost invariably with advances in the arts, with boldness and sagacity in exploiting new enterprises and new methods. None the less, this mode of sharply separating business profits from

in the higher rate paid for the factors of production, and on the other hand in the lower price of the product due to the greater supply.

Profits again are necessarily unstable. They last only as long as the economic fluctuation or variation from the normal condition continues. . . . If a manufacturer continually introduces new inventions, he may retain his superiority over his competitors. . . . In every case, however, as soon as the original force has spent itself and competition has set in, the profits tend to vanish.

In this sense, and in this sense only, it is true that profits tend either to an equality or to a minimum. . . . Interest is a part of cost; profit is a surplus above cost. Interest, as we shall see, has a normal rate; profits may have an average but no normal rate. *The marginal producer earns no profits. . . .* There is under normal conditions of progress a tendency in the rate of interest to fall, but, as we shall see, never to vanish; there is under competitive conditions always a tendency for the rate of profits in each individual business to disappear. Thus in ordinary enterprises profit is the great lure of energy, and competition the great destroyer of profit. Competitive profits, the union of both, are hence the symptom of progress. . . . *Profits are a result of price, not a cause of price.* Production at a lower cost creates profits; competition forces price down to lower cost and eliminates profits.

Profits are sometimes described as the wages of superintendence. *Wages however differ from profits in that wages are a stipulated income and profits a residual income.* There is a normal rate of wages, there is no normal rate of profits. *Wages are a part of cost, profits a surplus above cost. . . .* Above all, profits differ from wages in that profits are the direct result of price fluctuations." (Seligman—*Principles*).

wages seems to me artificial. Even the routine conduct of established industries calls for judgment and administrative capacity and for the exercise of the same faculties that are more conspicuously and more profitably exercised under conditions of rapid progress. To separate even roughly the earnings of a successful business man into two parts—one wages, the other 'profits' in the sense of gains from progress—would seem to be quite impracticable." (*Principles of Economics*, 1926, Vol. II., Chapter 50).

Examine the validity of the two following propositions:—(a) 'Profits tend to an equality'. (b) Profits tend to a minimum'. (C. U. 1933).

Some distinguished American economists—Clark and Seligman among others—maintain that in the long run and under condition of competition among rival producers, profit in every industry tends to a minimum or tends to vanish. This is so because competition in the long run forces every rival producer to lower cost and price of the product and also to offer higher prices to the factors of production, thus eliminating profit. As Seligman holds that in the long run and under competitive conditions profit tends to a minimum, or zero rate in every industry, therefore profits in all industries tend to be equal.

Extracts from Clark and Seligman, explaining their views, are given in the footnotes.

The validity of these two propositions has been questioned.

Marshall and the English economists generally are of opinion that there is a positive rate of profit (not a zero rate), and that normal profit is a part of the normal supply price of commodities. So English economists do not accept the view that profit tends to a zero rate and in that sense profits in all industries tend to equality. *For Marshall's view as regards profit tending to equality in a different sense, refer to page 418.*

In the actual industrial world to-day, competition is yielding place more and more to combination and monopoly—in much larger measure than could be foreseen by Marshall, Clark and other economists of their generation. This is the case with several leading industries in the United States, in Great Britain, in Germany and in other parts of continental Europe. Monopoly profit is usually high profit tending to a maximum rather than to a minimum. Profit under such conditions of combination and monopoly certainly does not tend to a minimum and perhaps does not tend to equality. Competition is an equaliser of profit. Not so monopoly. Different degrees of monopoly power in different industries lead to different degrees of profit.

Different theories about profit.

The word profit has been used in different senses and there are different theories of profits.

(1) **The theory of the early English economists.** English writers up to the middle of the nineteenth century do not separate interest on capital from the pure profit of the entrepreneur. These writers use the word, 'profit', to refer to the total gain of an individual capitalist, employing his own capital and also doing the work of management himself. *Profit* in this sense includes (a) *interest on the capital of the capitalist employer* and also (b) *his earnings of management*.

(2) **Walker's theory of profit.**

The fact that early English economists did not separate interest on the capital of the business man from his earnings of management was due to this—at that period business men worked generally with their own capital and not with much borrowed capital, and so the term profit was applied to the entire gain of the capitalist-employer due to his capital and also his management.

In America however employers working with borrowed capital have long become a dominant feature of the industrial organisation. And *Walker restricts profit* to mean only the *net gain of the employer, employing no capital of his own*. (Walker's profit does not thus include interest on capital).

Walker further maintains that *profits constitute a species of the same genus as rent*.

(1) As rent on superior land is paid on account of its superior fertility or superior convenience of situation, so profit is due to difference in the business abilities of employers.

(2) As there is no-rent land on which no rent is paid, (the produce of the land being only just sufficient to pay the expenses of cultivation and contributing nothing to rent), so there is a no-profits class of employers. The no-profits class of employers earn practically no profits, and they manage to subsist with great difficulty.

(3) As the rent on superior land is calculated from the no-rent land, so the profits of the superior employers are calculated by comparison with the no-profits class of employers.

(4) As the rent is not an element of the supply price of agricultural produce, so *profits also do not form a part of the price of manufactured products*.

Criticism of Walker's theory.

The following objections have been advanced against Walker's theory and his conclusions :

(1) The supply of land is inelastic, it has got no supply price and this gives a peculiarity to rent, the income from land. Profit is income of capital and business power ; and business ability in command of capital has a supply price, its supply is elastic.

(2) *A class of employers earning no profits also cannot permanently exist.*

(3) Business men are attracted towards undertakings by the profits which they will be able to realise. All prospective gains of the business man enter into the profits which draw him towards the undertaking, all the investment of his capital and energies in making the appliances for future production and in building up the immaterial capital of a business connection, have to show themselves to him as likely to be profitable, before he will enter on them.

Normal profit is thus an element of normal supply price, and forms part of the price of a manufactured product.

(3) Marshall's view.

By profits, Marshall refers to profits of capital and business power. Maintaining the continuity of the English orthodox view about profits, he uses the word to include (a) interest on the capital owned by the business man and invested by him in his business and (b) also his earnings of undertaking (risk-taking) and management (organising).

Profits in this sense constitute the reward of the capitalist for his risk-taking as regards his capital and also for his organizing.

Profits are thus justified from the standpoint of private property under present conditions.

(4) The Socialistic theory of profits.

For the socialistic theory which regards all profits as "legalized robbery" and for a criticism of that theory—see, the

Socialist Theory of Value, Part I, pages 440-442 and also Part II. Chapter on Socialism.

Profits per annum, and profits on the turn-over.

In profits per annum we look at the annual rate of profits on the capital invested in a business ; and the rate of profits on the turn-over refers to the rate of profits that is made every time the capital of the business is turned over.

Does the rate of profits tend to equality?

(1) The views of Seligman and some American economists.

Seligman maintains that in each particular occupation there is the tendency of competitive profits to a minimum, to a zero rate—and in this sense the rate of profits tends to equality in every occupation. Also he states that the tendency to equality is true of average profits as between different occupations.

Refer to Seligman, *Principles*, 1929, Chapter XXIII, also pages 413-414 of this book.)

(2) Marshall's opinion.

Marshall does not maintain that the tendency of competitive profits is to a minimum, to a zero rate. He holds that there is a normal rate of profit (a positive rate) in every industry. But he asserts that in the following sense the rate of profits tends to equality. (Marshall, *Principles*, 1928, Book vi, chapter viii).

~~There is~~ *There is no general tendency of profits on the turn-over to equality in all industries.* In some industries the rate on the turn-over is large, in other industries the rate on the turn-over is moderate and in some others the rate on the turn-over is low.

The rate of profits per annum also varies from industry to industry. Profits per annum are generally high in trades in which the work of management is difficult and risky ; where capital is relatively small and the wages bill is relatively large. The rate of profits tends to be low in trades, in which there is a disproportionately large amount of durable plant, that requires but little trouble and attention when once it has been laid down.

In trades in which the speculative element is not very important so that the work of management consists chiefly of superintendence, the earnings of management will follow very closely the amount of work done in the business and a rough measure of this is found in the wages bill.

The rate of profits on the turn-over varies much more widely than the annual rate of profits on capital.

(1) Though there is no general tendency of profits on the turn-over to equality, there is *in each trade* and in every branch of each trade a more or less definite rate of profits on the turn-over which is regarded as a fair or normal rate.

(2) In the words of Marshall, *the least inaccurate of all the broad statements that can be made with regard to a general tendency of profits to equality in different trades* is that where equal capitals are employed, profits tend to be a certain percentage per annum on the total capital, together with a certain percentage on the wages-bill. It is in this sense that profits may be said to tend to some rough sort of equality.

A criticism.

Competitive profits tend to equality under certain conditions. Not monopoly profits. Even Marshall's careful and guarded statement about the tendency of profit to equality under certain conditions is becoming less and less applicable to the modern world with increasing tendency to monopoly and combination.

I. Relation of wages to profits.

(1) The relation of wages to profits is to be studied under two aspects. *In the long run* wages and profits are complementary in the sense that business prosperity may mean both high profits and high wages.

(2) On the other hand, the *immediate* division of the product in each individual case and at any given moment antagonises wages and profits. The more that is taken as profits by any single employer or group of employers, the less will be left for wages.

II. Wages and profits compared.

(A) Business profits resemble wages in certain points ; and so Taussig says that profits are best regarded as simply a form of wages.

(B) Yet the differences between business profits and wages in certain points are very great.

(a) *The leading characteristic of the business man's work differentiating it from the work of the ordinary workman is that the business man stands at the helm of industry and guides its operations. Into his hands first flow the proceeds of the business, and it is he who distributes to the other agents of production their shares. He gets as his profit what is left after paying the other agents of production—the income of the business man, his profit has been therefore described as a residual share.*

(b) *The irregularity of the business man's income (his profits) offers a striking contrast to the much greater regularity of the rate of wages. (1) The same enterpriser may have a very large profit this year and next year he may have no profits at all ; but the wages of the same workman will not fluctuate so greatly from year to year. (2) Again the wages of labourers of the same grade do not vary by any considerable amount while the variations in the profits of business men of the same grade are much more considerable due to the chance elements in profits.*

The differences in the profits of different entrepreneurs belonging to different grades are very great ; and such great differences are not to be found in the wages of labourers of different grades. And to what facts are these great differences of profits due ? It is due in some measure to chance but largely it is due to the possession by some individuals of qualities not possessed by others.

(d) There is thus a larger element of quasi-rent of ability in profits than in wages.

(e) *With the fluctuations of prices, profits fluctuate and the fluctuation in the rate of profit is greater than the fluctuation in price. The fluctuations of the business man's profits precede*

fluctuations in wages and are more extensive. *A small rise in price will often increase very greatly the profit of the business man and will lead to a rise in wages which is much less extensive.* And as the rise in wages is not generally in proportion to the rise in prices, the real income of wage-earners will diminish and they will suffer while the business men will be enjoying prosperous times.

• Interest and profits.

Early English economists did not distinguish between interest and profit. At this stage, the employer was also a capitalist and the total income of the employer-capitalist was regarded as his profit; and this total income included interest on the capital invested and also the remuneration for business management or organization.

Summary.

1. Profit is the income of the entrepreneur. It is the excess of the sale price over the cost price.

2. What is left in the hands of the employer after he has paid contract wages, rent and interest is his gross profit.

The *gross profit* of the employer includes (1) *pure profit*, (2) normal return upon the employer's own land, capital and service of superintendence, (3) monopoly gains and also conjunctural gains.

Theory of pure profit.

Pure net profit is a differential return due to the superior ability of the entrepreneur and in some respects resembles rent. The marginal entrepreneur gets no pure net profit.

4. Early English economists use the word profit to include (a) interest on the capital of the capitalist-employer and (b) also his earnings of management.

Walker narrows the meaning of profit to mean only the net gain of the employer employing no capital of his own. Walker's profits thus excludes interest on capital. And he maintains that profit constitutes a species of the same genus as rent, and that profits do not form part of the price of manufactured products.

5. There is a general tendency of profits to a rough sort of equality in the sense that when equal capitals are employed, profits tend to be a certain percentage per annum on the total capital together with a certain percentage of the wages-bill. calculated?

Questions.

1. Analyse profit, and describe how each item constituting it is determined. (C. U. Hon., 1932).

What are the constituent elements of profits? (C. U. 1928).

Analyse the nature of profits. Do you agree with the view that in a static society profits would cease to exist as a distinctive element in the distribution of wealth? (C. U. Hon. 1929).

2. What do you understand by gross profits? Distinguish between gross and net profits. What are net profits? How are net profits to be

3. Sketch briefly the theory of net profits. In what respects does the theory of net profits resemble the theory of rent?

4. Discuss the following statements of Walker :

(i) Profits are a species of the same genus as rent.

(ii) Profits do not form part of the price of manufactured products (1909).

5. In what sense do profits tend to a minimum and to an equality?

6. Distinguish between (a) profit and interest, (b) profit and wages. (1909, H.).

7. Discuss the nature of profits. Are profits "legalised robbery"? What is the economic justification of profits? (C. U. 1917). Critically examine the Socialistic view of profits as a share in distribution. (C. U. 1922).

BOOK VI.

THE STATE AND ECONOMIC LIFE.

CHAPTER I.

Public Finance.

(Public finance is that branch of economics which deals with the revenues and expenditures of governments and with the administration of such revenues and expenditures.)

Carl Plehn defines public finance as "the science which deals with the activity of the statesman in obtaining and applying the material means necessary for fulfilling the proper functions of the state."* The expenditures of the state are for performing the state functions, and to meet these expenditures the state has to raise revenues and to administer them.

Importance of public finance in modern times.

(1) The total amount of public expenditures at the present time is of enormous dimensions and an enormous aggregate of public revenues has to be raised every year to defray these expenditures.

(2) Not only the total of public expenditures is very large, it is increasing and it is increasing at a very rapid rate. The gradual expansion of public expenditures is being brought about by the expansion in the functions of modern governments. A modern government performs many duties in connection with the poor and unfortunate, in connection with sanitation, education and public works etc., which were not undertaken by governments of earlier periods.

Government business is the largest single business in every advanced modern state. The total expenditures and revenues of a government every year are much larger than the revenues and expenditures of the richest multi-millionaire within the

state. The government is the largest employer of labour within the country and so influences greatly rates of wages and conditions of employment for labour. And government business is not only vast in its extent, the influence (direct and indirect) that the government revenues and expenditures exercise upon the production, distribution and consumption of wealth is enormous.

(3) *The war has enormously increased national expenditures and has multiplied many times national debts*—the English national debt during the war has increased from about 600 million to about 8,000 million, more than ten times, and similar increases have taken place in other countries.

For all these reasons a study of the activity of the state, its revenues and expenditures, is of great importance.

The law of increasing public expenditures.

The immense increase in public expenditure within recent times has led to the formulation of the law of increasing public expenditures by Prof. Adolf Wagner, one of the leading economists of modern Germany ; and the law is thus translated by Prof. Ely :

"Comparisons between different countries and different periods show regularly among progressive nations an extension of public activities. This manifests itself extensively and intensively ; the state and its subordinated political units continually undertake new functions, and they perform their duties, old and new, better and better.

In this way, that is through public agency, the needs of the population to an increasing extent, specially their common needs, are satisfied ; and the public services for satisfaction of needs continually improve in quality. The clear proof of this is given statistically in the increased demands made by the states and the subordinate political units."

This tendency towards increasing public expenditures became remarkable in the period 1890-1914 ; and as already noted, the increasing public expenditures of most modern states were enormously increased during and after the last world-war.

Divisions of Public Finance.

The subject of public finance has four principal divisions :—

- (1) Public Expenditures
- (2) Public Revenues
- (3) Public Debts
- (4) Financial Administration.

Fundamental Principle of Public Finance.*

The fundamental principle of Public Finance (as indeed of all Economics and Political Science) is* *the principle of general welfare—the principle of the greatest social good for the community.*

All public expenditures are to be judged from the standpoint of this principle. All the revenues (taxes and other revenues) which the state raises to meet its public expenditure are to be examined from this standpoint. Whether a tax is good or bad, whether the tax system in a country is satisfactory or otherwise can be known by examining the burden of the tax and also how the tax revenue is spent, and whether on the whole considering the immediate and ultimate effects the general welfare has been promoted.

PUBLIC EXPENDITURES.

Principles regulating public expenditure.

(The fundamental principle regulating public expenditure is general welfare—all public expenditures are to be incurred to

* Dr. Dalton on the Principle of Maximum Social Advantage.

Unlike many British economists, Dr. Dalton emphasises the importance of having one fundamental principle at the root of Public Finance. He calls this principle—the Principle of Maximum Social Advantage. But we have seen that really one fundamental principle—the principle of general welfare (Dalton calls it the Principle of Maximum Social Advantage)—lies at the root of Public Finance, indeed all Economics and Political Science.

"If, therefore, public finance is to be treated as a branch of science, economic or political, and not merely as a string of catchpenny maxims,

promote the welfare of the people in different ways. The maximum result should be aimed at.

Progressive states find it advantageous to assume different functions at different periods; and on the whole there is a

one fundamental principle must lie at the root of it. This we may call the Principle of Maximum Social Advantage: Most of the operations of public finance resolve themselves into a series of transfers of purchasing power. These transfers are made by taxation or otherwise, from certain individuals to public authorities, and back again from these authorities, by way of public expenditure, to other individuals, some of whom, such as policemen or contractors, render services in return, while others, such as old age pensioners, do not. . . . As a result of these operations of public finance, changes take place in the amount and in the nature of the wealth which is produced, and in the distribution of that wealth among individuals and classes. Are these changes in their aggregate effects socially advantageous? If so the operations are justified; if not, not. The best system of public finance is that which secures the maximum social advantage from the operations which it conducts. This principle is obvious, simple and far-reaching, though its practical application is often very difficult.

In seeking to apply this principle we need to have before us certain tests of social advantage. The first which suggests itself is the need to preserve the community, assuming it to be worth preserving in its existing form, against internal disorders and external attacks. How this should best be done falls outside the scope of this discussion. But it is a question of wise public policy at home and abroad, and not merely of expenditure on armaments and police. . . . And, in any case, it is their business to try to increase the welfare, both economic and non-economic, of its members.

This brings us naturally to the more strictly economic tests of social advantage, with which this book is primarily concerned. The two chief conditions of an increase in the economic welfare of any community are, first, improvements in productive power, and second, improvements in the distribution of what is produced. Improvements in productive power resolve themselves into mere increases of productive power, so that a larger product per head of the population shall be obtained with a smaller effort, and improvements in the character of what is produced, so that a given amount of product shall go further in satisfying economic needs, and shall thus give rise to greater economic welfare. Improvements in distribution resolve themselves into a reduction in the great inequality, which is found in most civilized communities, in the incomes of different individuals and families, and a reduction in the great variability, between different periods of time, of the incomes of particular individuals and families, especially among the poorer sections of the community.

It should be added that the statesman is a trustee for the future, no less than for the present. Individuals die, but the community, of which they form a part, lives on. The statesman, therefore, should prefer a larger social advantage in the future to a smaller one to-day" —Dalton, *Public Finance*, 1930, pages 9-12.

distinct tendency on the part of the modern state to extend gradually its functions. Whether it is desirable or not on the part of the state to undertake certain functions and to incur public expenditures in connection with these—in answering this question, *the statesman should not be guided by dogmatic theories of laissez faire or dogmatic theories of paternal interference.*

He should be guided by a careful consideration as to whether the advantages to the society in that particular case outweigh the disadvantages, whether the welfare of the society is on the whole increased on the state undertaking those functions.

In connection with public expenditures, certain general considerations suggest themselves.

(1) The amount of public expenditures should be such as would not absorb an unduly large proportion of the income of citizens, it should not impose excessively heavy burdens upon the people. No hard and fast rule can be given. (See *Wealth and Taxable Capacity*, pages 438-439.)

(2) Public expenditures should be economical, in a double sense (a) they should avoid waste (b) they should attempt to avoid all indirect evils. (3) There should be facilities for public criticism and adequate check. (4) And finally these expenditures should be elastic—increasing with the resources and the needs of the state and diminishing with a decrease of resources or needs.)

Classifications of public expenditure.

Many different principles of classification have been followed by different writers on this subject.

I. A classification made with respect to the political units which control the expenditure is given below :

(a) Public expenditure by the central government of a country (i.e., the Government of India or the federal government of the United States).

(b) Public expenditures by provinces and state governments (e.g., the provincial governments of India or the state governments of the United States).

(c) Public expenditures by local units, e.g., the Indian district boards and municipalities and corresponding political units of other countries.

II. A classification made with respect to objects of expenditure is the following :

(a) Expenditure for national defence (viz., army, navy, aircraft etc.) and for police, jails etc. to maintain internal order.

(b) Expenditure for the poor and helpless.

(c) Expenditure for education and culture (schools, universities, museums, picture galleries etc.).

(d) Expenditure for industry.

III. Plehn's classification.

He classifies expenditure into (a) expenditure exclusively for the common benefit—the expenditures for the common benefit are classified into (i) expenditure for general administration, (ii) expenditure for the legislative department (iii) expenditure for public buildings (iv) expenditure for public defence (v) expenditure for means of transportation (vi) expenditure for education (vii) expenditure for assisting private industries and commerce.

(b) Expenditure for the benefit of individuals.

The expenditure for the benefit of individuals includes (i) expenditure for charities (ii) pensions for public servants (iii) bounty and protection (iv) expenditure for the administration of justice (v) expenditure for the betterment of the property of individuals (vi) expenditure in public industries.

Productive and unproductive expenditure.

What the government spends (1) for developing the natural and material resources of the nation by investing funds in profit-earning railways, irrigation works, etc., or for the promotion of agricultural and industrial development and the general economic development of the country including afforestation, development of harbours, rural transport etc. (2) for developing the human resources of the nation by means of educational expenditure, expenditure on public health, etc.—all this is

productive expenditure. What the Government spends on wars and armaments leads to the destruction of the material and human resources of the nation—this is unproductive expenditure from the economic point of view. But such 'unproductive expenditure' may become necessary for maintaining the national independence of a country or for other political reasons.

State Expenditure and Distribution.

State expenditure may affect distribution in different ways.

The state may take money by taxation from the rich and give this money directly to the poor—thus is done practically under the Old Age Pensions scheme introduced in Britain in 1906 for granting pensions under certain conditions to the aged poor above the age of 70.

The state may raise money from the richer classes by means of a high rate of income-tax and high death-duties, and it may spend the money largely in educational and public health expenditure for the benefit of the poorer classes as in Britain—this practically transfers some wealth from the rich to the poor, and thus distribution is affected by State Expenditure.

The modern tendency in all progressive states is to redress some part of the existing inequalities of wealth among the different classes by State Expenditure and also by the method of levying State Revenue.

The great danger of such attempted re-distribution is that it may check the production of wealth in the country (1) by reducing the productivity of the rich capitalist and employing classes (2) by making the poorer classes too dependent on state help.

PUBLIC REVENUES.

We have next to see what are the different classes of revenues which are raised in modern states to meet the public expenditure.

As there are different classifications of public expenditures so there are different classifications of public revenues by different writers.

(A) Public revenues may be usefully classified in the following manner :

1. **Extraordinary Revenues** consisting of the public loans.

2. **Ordinary Revenues.**

I. Revenues derived directly from Government ownership.

(a) Revenues from public domains, *e.g.*, land, forests, mines, etc., owned by the Government in proprietary right.

(b) Revenues from public industries, *i.e.*, industries owned and managed by the Government, *e.g.*, the post office, many railways in India, railways in France, Japan, Germany, etc.

(c) Revenues from interest, investments etc., *e.g.*, the interest on the Suez Canal shares owned by the British Government.

II. Revenues derived from the incomes of private persons and corporations (a) Fees, (b) Taxes.)

(B) Prof. Plehn classifies revenues according as they are justified (a) by common (b) or special benefit ; and we have seen that he has followed the same principle in classifying public expenditures.

Public domains.

The revenues from public domains consist of the revenues from agricultural land, mines and forests, etc., owned by the state and managed in the interests of the public revenue. The revenues from public domains constituted the most important source of public revenues in earlier times. The oldest form of public property is land and the public land originally embraced all the territory of the state.

The German states are in favour of retaining their domains in lands and forests and they derive a considerable revenue from these sources. On the other hand, in England, France and the United States the policy of steadily diminishing the public domains has been and is being followed.

Modern English and American writers do not favour the public ownership of agricultural land because land under public

ownership (except when in charge of a highly trained body of expert officials as in Germany) does not form a satisfactory source of revenue.

The public ownership of forests is however generally advocated. This is due to the fact that (a) the Government in its management of forests takes into account the interest of the community as a whole and this the private owner does not (b) the Government being a permanent institution can afford to wait for a long time for the economical use of timber land but this the private owner cannot (c) and that Government management is made practicable on account of the routine character of the business.

Land nationalisation.

This subject is treated in the chapter on Rent.

Public Industries.

Industries which have succeeded well under government management have been *generally industries of a monopolistic character* (e.g., the supply of water or gas in towns etc., can be made to yield a considerable public revenue). Industries which are naturally competitive should be left to private hands except in certain cases where political considerations or the desire for national industrial expansion make state interference and control necessary and inevitable. (Refer to Book VI, Ch. ii).

Fees and special assessments.

(a) **Fees.* The state in the exercise of its functions sometimes confers special benefits upon particular individuals. (*A fee is a payment made by a citizen to the state for some special services rendered by the state to the citizen, and the service being largely non-commercial in character.*)

* "The essential characteristic of a fee is the existence of a measurable special benefit together with a predominant public purpose." "The absence of public purpose makes the payment a price; the absence of special benefit makes it a tax." Seligman—*Essays in Taxation*.

(The litigant who pays the court fee for instituting a suit in a Court derives a special benefit from the payment of that fee,—the special benefit is that he is allowed to bring his case before the Court.

Some examples of fees are—fees for passports, fees for recording mortgages, for recording marriages, etc.)

* (Among modern progressive nations, it is found that the relative importance of fees as a source of public revenue is declining, and that a greater and greater portion of public revenue is being raised not by special contributions like fees but by general contributions like taxes.)

(b) Special assessments.

A special assessment is a compulsory contribution levied upon the property of private individuals in proportion to the special benefit conferred upon the property which is improved in value by public expenditure undertaken in the public interest.

In the United States of America, a city often provides for the expense of improving a particular street (a) by laying part of the cost upon the municipality in the form of a tax and (b) by raising the rest of the money required in the form of a *special assessment* upon the properties of those citizens which are increased in value by the improvements undertaken by the municipality.

TAXATION.

The poet has complained "The world is always with us"; citizens in every modern state often more loudly complain "taxes are always with us." The *theory and practice of the modern state* in every country is to tax all citizens if possible. (Refer to the modern conception of the connection between *Taxation and Citizenship* in the extract from the Colwyn Report in pages 479-480).

Ancient states also had their taxes. In the statement attributed to Jesus Christ "Render.....unto Cæsar the things which are Cæsar's."—(*Matthew, xxii, 21*), we have Christ's conception of the citizen's duty to pay all taxes due to the state.

The finance minister of a modern state, like Homer's *Odysseus*, must be a man of many counsels. A satisfactory system of taxation will require a variety of taxes. Refer to Direct Taxes and Indirect Taxes on pages 450-455.

Definition of a tax.

(A tax is a compulsory contribution, levied upon persons (natural or corporate) for the general purposes of Government.)

The modern definition of a tax emphasises two elements:

(1) A tax is compulsory.

(2) It is not a measured payment for benefits received by individual tax-payers. In other words, a tax-payer does not pay taxes in the modern state in proportion to the benefits which he receives from the state. Taxes are thus distinguished from prices—a price is a measured and proportionate payment.

(Eas and special assessments are contributions made by persons to the government for special benefits received by them; taxes are levied to defray the expenses of the state for conferring common benefits upon the citizens of the state, and not special benefits to particular persons.)

* *(Taxation is by far the most important source of public revenues in all progressive modern states. India raises almost half of her public revenues from non-tax sources; and this is because heavy taxation of the ordinary kind as practised in rich and progressive countries would be impracticable in such a poor country as India. In England, France, the United States and other wealthy and flourishing countries, taxation provides much the greater proportion of the public revenues.)*

In discussing this subject of taxation we shall have to examine two classes of questions: (i) *Taxation in general, canons or principles of taxation, theories about equity (justice) in taxation etc.*, and (ii) *particular taxes.*

Taxes under actual and imaginary conditions.

Suppose all persons in a country earn equal incomes. Then a single tax taking the same percentage of income from all persons will secure justice and a sufficient percentage will secure adequate revenue for the state. Taxation under such imaginary conditions is an easy task for the Finance Minister of the State.

Under actual conditions in the capitalist and competitive countries, like Germany or Britain or the U. S. A., all persons do not earn equal incomes. The vast majority in every such nation consists of labourers having low or moderate incomes. Businessmen have much larger incomes. Also there are many unearned incomes—large as well as small. There are great inequalities in income. Also there are great inequalities in wealth as between different citizens in the country. These differences in income and wealth make the task of the Finance Minister in securing a substantial measure of justice as between tax-payers and at the same time a sufficient revenue for the State, a task of considerable complexity. He has to levy different kinds of taxes and has to adopt various precautions.

The Socialist State has not to levy any taxes. Industry is state-owned and state-managed. The State gets all income that it requires from state-owned and state-managed industry. There are no private employers and no private business and no taxation of private business.

The State in relation to taxation of all citizens if possible

Refer to pages 479-480 of Vol. II of this book and to pages 239-240 of the Colwyn Report.

*** Canons (or principles) of Taxation.**

(Every country must carefully adjust its taxation system (indeed its entire system of revenues and expenditures) to its economic, political and social conditions, its moral ideals, its history and in some degree even to its prejudices.

For example high progressive rates of taxation on income and on property were condemned by the moral, political and

* *Prof. Cannan has his own sharp distinction between Equity and Economy as criteria of taxation, the term of Economy "being, of course, understood not in the vulgar sense of spending little, irrespective of the return to the expenditure, but in the sense of the best utilisation of available means."* "No government can afford to disregard the ideas of equity entertained by its subjects at any particular time. It is no use to try to forget the fact that men are generally prepared to sacrifice their economic interests on many altars, one of which is dedicated to Justice. But of the two principles, Equity and Economy, Equity is ultimately the weaker. History, and indeed the recollection of every middle-aged man, provide instances which go to show that the judgment of mankind about what is equitable is liable to change, and that one of the forces which cause it to change is mankind's discovery from time to time that what was supposed to be quite just and equitable in some particular matter has become, or perhaps always was, uneconomical" (*History of Local Rates*, pages 160, 173).

social ideals of the community in Britain some years ago; now these high progressive rates of taxation on income and property are supported by the moral, social and political ideals of the people in Britain, they have been introduced in Britain and form very important parts of the Public Revenues, and they have been made also necessary by the great inequalities of wealth among different classes in modern times and the heavy increase in government expenditures during and after the last world-war.

The chief canons or general rules relating to taxation are the following :

(1) The principle of sufficiency.

(The taxes must be adequate so as to raise a sufficient revenue for the state—an annual recurring deficit is a great political and economic evil and it must be prevented.) If the revenue required for enabling the state to discharge its proper functions, if this revenue cannot be raised by good taxes only it will be necessary to levy even some taxes of somewhat inferior quality—specially this has to be done in war time and other periods of stress.

(2) The principle of equity (justice) in taxation.—All writers are agreed that equity in taxation is a fundamental requisite—the burden of taxation should be distributed equitably among all classes of the population. Now how is justice in taxation to be secured? Economists and financiers are by no means unanimous on this point, but the opinion widely accepted among modern economists is that equity (justice) is best secured by following the ability or the faculty principle. Persons should be taxed by the state, in proportion to their ability to contribute. And for this progressive taxation is necessary.

For a discussion of the question of equity (justice) in taxation, refer to pages 440-445.

(3) The principle of economy.

(This principle declares that other things being equal those taxes are most suitable and should be chosen (i) the cost of collection of which is small, in proportion to the revenue pro-

duced by the tax, (ii) the indirect loss occasioned by which to the country is small in proportion to the proceeds of the tax. A tax which would require a large number of officers to supervise the collection of the tax would be expensive and would be opposed to the principle of economy. *Taxes which hamper production or injuriously affect consumption are also against this principle of economy.* A tax upon an industry, subject to the law of increasing returns, would cause a considerable loss of consumer's surplus to the country and would be thus opposed to this principle. Taxes upon the consumption of injurious articles, e.g., alcoholic liquors and other intoxicants would diminish the consumption of these things and would be quite in accordance with the principle of economy.

Also as far as possible taxes should be so selected as to cause the least possible amount of inconvenience to the taxpayers as regards time, place and mode of payment etc.

(4) The principle of certainty.

Taxes should not only be equitable, economical, they should also satisfy the principle of certainty.

The principle of certainty maintains that taxes should be framed in such a manner that people who have to pay taxes should be certain *what* they have to pay, *when* they have to pay.)

(5) The principle of variety.

Every tax tends to bear unjustly upon some particular class of people ; so there should be variety in the matter of taxes, there should be different kinds of taxes, neutralising the defects of one another.

(6) The principle of flexibility.

A country has sometimes to increase its public revenues to meet a temporary or a permanent increase in the public expenditure. The tax system of a country as a whole, should be flexible in the sense that the total tax revenue can be increased within reasonable limits by increasing the rates of all or some of the taxes of that system, without altering substantially the distribution of the burden of taxation upon

the different classes of the people. Flexibility is not only desirable in any particular tax, it is eminently desirable in the tax system as a whole.

The income tax in Britain has great elasticity in itself, and it introduces a highly valuable element of flexibility in the entire tax system of Britain; it has been introduced in India and recently in France which for a long time was opposed to it.)

• Notice that the principle of certainty is practically an application of the principle of economy with the object of securing the convenience of the tax-payer as much as possible, so that he may have the minimum of inconvenience; that the principle of variety is practically an application of the principle of equity (or justice) in taxation, and it tries to secure equity or justice in taxation through a variety of taxes; that the principle of flexibility tries to secure justice and also a sufficient revenue and is thus deducible from the principles of equity and sufficiency. *So the principles of equity, sufficiency and economy are the three fundamental canons of taxation.*

Adam Smith's canons of taxation.

Adam Smith's four celebrated canons of taxation have exerted a notable influence in the history of financial theory and they possess considerable historical importance. They have however been criticised by recent writers, Walker being specially prominent in this connection. Adam Smith's canons are given below:

I. The canon of ability.

The subjects of any state ought to contribute towards the support of the government, as nearly as possible in proportion to their respective abilities i.e. in proportion to the revenue which they respectively enjoy under the protection of the state

II. The canon of certainty.

The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and every other person.

III. The canon of convenience.

Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.

IV. The canon of economy.

Every tax ought to be so contrived as to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury.)

These canons of Adam Smith have been accepted by many economic writers but within recent years they have been subjected to criticism. (Adam Smith's canon of ability practically corresponds to the modern canon (or principle) of equity.) His canons of certainty, convenience and economy may be still accepted.

Sir Josiah Stamp on a three-fold treatment of taxation questions.

In connection with the canons of taxation it is to be noted that taxation questions may be looked at from three different standpoints :

- (1) The standpoint of the individual taxpayer.
- (2) The standpoint of the Government imposing the taxes.
- (3) The standpoint of society as an economic organisation producing, exchanging and consuming things.

Sir Josiah Stamp maintains that "most taxes in practice represent the best practical compromise between the three standpoints that can be arranged in the particular circumstances of the time."

From the standpoint of the individual taxpayer, his ability to pay is to be considered and also how ability is to be measured by income or expenditure or both and also how his income is to be calculated, what exemptions and concessions are to be granted and also the question of progressive versus proportional taxation.

From the standpoint of the state, the state as a tax-gatherer has to consider (1) whether the tax is economical and the cost of collection is moderate; (2) whether it is practicable and within the powers of the administration for assessment and collection; (3) whether it is specially liable to fraud and evasion; (4) whether the imposition of the tax tends to dry up the source of the tax; (5) whether it raises political difficulties at home and provokes unrest; (6) whether it raises international difficulties.

From the standpoint of the economic society we have to consider the economic effects of the tax on production, distribution, exchange and consumption of wealth, accumulation of capital etc. For example, progressive taxation is advocated among other reasons on the ground that it secures a better distribution of wealth within the community. Also we have to consider certain non-economic effects, e.g. the health of the community, the prevention of crime etc. in connection with the taxation of things like alcoholic liquors.

Wealth and Taxable Capacity.

The idea of taxable capacity of the people or a limit to the taxable capacity has developed recently in connection with the heavy expenditures of modern governments during and after the last world-war and

partly also in connection with the question as to how far Germany can be made to pay the expenses of the War.

What is the taxable capacity of a country?

Is it what the people living in that country can afford to pay as taxes to the government? Or, does the taxable capacity depend upon the income produced in that country, whether part of the income produced goes away from the country or not?

Most states in modern times tax under both principles, viz., the principle of residence and the principle of the origin of income—thus giving rise to the problem of double taxation. Britain taxes under both principles and so for taxation purposes the income of the British people is calculated as the national income produced in Britain plus the income which British investors derive from their investments in foreign countries.

We approach the subject of the taxable capacity of a people by calculating their aggregate income minus the aggregate amount required for the subsistence of the population. So the taxable capacity decreases if the aggregate income remains the same but the aggregate amount required for the subsistence of the population increases because of increase of population. Again if the standard of consumption among the people is lowered during a war and after it and the people are ready to make sacrifices in consumption on account of patriotic or other reasons then the taxable capacity of the people is increased. **"This question of taxable capacity is necessarily relative—relative not merely to our production, but also to how much we desire to save and how little we are prepared to consume . . . taxable capacity is measured by the difference between two quantities—the total quantity of production and the total quantity of consumption."*

Sir Josiah Stamp discusses several reasons as to why the limit of taxable capacity of a people is relative and not an absolute or fixed figure :

* Sir Josiah Stamp—*Wealth and Taxable Capacity*. *

(1) The limit of taxable capacity depends upon what the taxation is to be raised for, whether for reduction of debt or payment of interest on debt within the country or payment of debt out of the country.

(2) It depends upon the spirit and national psychology of the people taxed, which may be influenced by patriotism or sentiment.

(3) It depends partly on the way the taxation is raised, both as to the methods adopted and the rate at which the increase is laid on.

(4) It depends on the distribution of wealth.

(5) Its rate of increase is greater than the rate of increase in wealth and it shrinks more rapidly than wealth diminishes.

* Theories about equity (justice) in taxation.

What is the idea of just taxation? This is a question of the greatest theoretical interest and practical importance in public finance. It is a question which has engaged the earnest attention of economists and statesmen all over the civilised world. There are numerous theories on this subject and some of these are given below.

It is clear that equal amounts of taxes from a rich man and from a poor man will not secure justice—for the rich man with an income of a lakh of rupees every year and paying a tax of Rs. 30 a year pays a very small percentage of his income, while a poor peasant with an income of Rs. 60 a year paying the same amount of Rs. 30 a year as taxation will have very little left for his own wants.

* Walker on the ideal tax.

The ideal tax, according to Walker, is a tax on faculty. Faculty (the power of production) constitutes the only theoretically just basis of contribution. Suppose a work of general concern requires to be constructed. All able-bodied persons should turn out, and each man work according to his faculties, in the exact way in which he could be most useful. This is the form of contribution which is prevalent in all primitive communities; and the largest tax of modern times, viz. compulsory military service is assessed and collected precisely on this principle.

Walker admits that the faculty tax though it is the ideal tax is impracticable as the sole tax, in a complicated condition of industrial society. Hence we have the different taxes on expenditure, on income, on capital etc.

Purely 'economic' theory of Taxation.

This theory boldly proposes to abandon altogether the attempt to follow out the equities of contribution. Walker sums up the theory thus: "Why make the hopeless effort to apportion the burdens (of taxation) with absolute justice? Get the best government you can; maintain it at the least expense consistently with efficiency; collect the revenue for the service by the most convenient, simple and inexpensive means." And in this connection Walker quotes McCulloch: "The distinguishing feature of the best tax is not that it is most nearly proportioned to the means of individuals, but that it is easily assessed and collected and at the same time, most conducive to the public interest." The purely 'economic' theory of taxation is opposed to the modern social conception of securing justice in taxation as among the different tax-payers; and it is now generally rejected.

(i) The benefit theory.

This theory maintains that justice in taxation is secured by taxing each citizen in proportion to the benefit he receives from the activity of the state.

The benefit theory is open to the following objections :

(a) In a certain sense the weak and the poor receive the greatest benefit from the Government. In a modern progressive country like Britain they get free education and are, if necessary, maintained at the government expense. Though they receive the greatest benefit they are however least able to bear the burden of taxation ; and it would be unjust and immoral to tax these poor men in proportion to the benefits received by them.

(b) Again as regards different classes of society it is impossible to point out exactly what proportion of general benefit goes to particular individuals. So taxation in proportion to benefits becomes impracticable.

(The benefit theory really applies not to taxes but to fees and special assessments which are levied in proportion to benefits received by persons making these payments).

(ii) * The equal sacrifice theory.

Many writers maintain that taxation to be just, should cause *equal sacrifice among the tax-payers.*

* Pigeon on the rival claims of *least aggregate sacrifice* and *equal sacrifice* to serve as ultimate principles of taxation.

"Some authorities hold that to make the aggregate sacrifice associated with the raising of revenue as small as possible is an ultimate principle : others that to make the sacrifice borne by all the several members of the community equal is an ultimate principle :

In my view there can be no question that, subject to the qualifications set out in §2, least aggregate sacrifice is an ultimate principle of taxation. . . . So far as political theory is concerned, maximum aggregate welfare is everywhere accepted as the right goal of government. . . . In the special field of taxation this general principle is identical with the principle of *least sacrifice*. Its validity appears to me to be given directly in intuition.

The claim that *equal sacrifice* is an ultimate principle of taxation is more controversial . . . there is at least as good a case for taxation that makes net satisfaction equal as for taxation that makes sacrifices equal. Indeed there is a better case.

We have *one ultimate principle, namely, least sacrifice, whose claim*

Equal sacrifice is taken by some writers to mean *equality of proportional sacrifice* and not equality of absolute sacrifice. In other words the taxpayers after payment of the tax should occupy the same relative positions, which they occupied before they were taxed. (So according to the equal sacrifice theory taxation should be so framed that the marginal utility of income of different tax-payers is affected in an equal degree by the taxation imposed.)*

This theory accepts the existing distribution of wealth as just and it holds that taxation to be equitable should leave present distribution undisturbed by imposing a proportional sacrifice upon the taxpayers.

Edgeworth's theory of minimum sacrifice.

J. S. Mill in advocating equality of sacrifice between individuals in the matter of taxation held that the principle of equality of sacrifice was fair to individuals and that it would lead also to the least sacrifice for the community as a whole.

But Mill was wrong.

Suppose that it causes equal sacrifice to take Rs. 10 from a man with an income of Rs. 500 a year and Rs. 1,000 from a

is undisputed: and a *second ultimate principle, equal sacrifice among similar and similarly situated persons*, but not among others, whose authenticity is somewhat less secure. If the second of these principles is recognised as well as the first, there is, for analysis, a conflict of ideals. Both the "ultimate" principles must be brought before the tribunal of something more ultimate still, i.e. the principle of maximum good, and weights must be assigned to them so proportioned that good as a whole, including the good of equality, shall be made as large as possible. In practice, however, as will appear presently, tax arrangements that conform to the principle of least sacrifice always and necessarily conform also to the principle of equal sacrifice among similar and similarly situated persons. . . . Though, therefore, for academic persons there may be a more complex esoteric doctrine, for politicians and men of affairs we may properly assert that least aggregate sacrifice is the one ultimate principle of taxation"—A. C. Pigou, *A Study in Public Finance*, 1928, pages 58-61.

* By equality of taxation, some economists mean that taxation should involve the equality of sacrifice on the part of the tax-payers. My suggests that equality and uniformity in practical application have come to mean little more than this, that taxation shall not be arbitrary, capricious, or plainly unreasonable, and that within each class of persons or objects the burden shall be equal.

man with an income of Rs. 50,000 a year ; but even then it will cause less sacrifice to the community to take Rs. 1,000 as taxation from one man with an income of Rs. 50,000 a year than to raise the same sum of Rs. 1,000 in taxation by taking Rs. 10 from each of one hundred men with an income of Rs. 500 per head per annum. This is the substance of Edgeworth's theory of minimum sacrifice.

Edgeworth's theory of minimum sacrifice has substantial theoretical merits ; but it cannot be followed as a practical policy. If following this theory taxation rising to 100 p.c. was concentrated on the highest incomes, such incomes would disappear and then taxation would fall on the lower incomes ; and such heavy taxation of the highest incomes would check the growth of capital and production of wealth in the country.

Pigou's discussion of *the rival claims of least aggregate sacrifice and equal sacrifice* as ultimate principles of taxation is interesting and important. See pages 441-442, foot-note.

(iii) The faculty theory. *a.k.a.*

Many economists are of opinion that justice in taxation can be secured by following the faculty or ability principle. Taxation should be levied upon persons in proportion to their faculty or ability to pay and not in proportion to benefits received by them.

In theory it is just that men should be made to help the state revenue in proportion to their power to help themselves.

Persons who can earn large sums for themselves and so have ability to pay heavy taxes should be made subject to heavy taxation though these persons may not derive much direct benefit from the taxes ; and the poorer classes who cannot earn much for themselves have comparatively less ability to pay and so they should be taxed lightly though they may derive much direct benefit from the proceeds of taxes. *Faculty is a better criterion than benefit.*

Now how is faculty to be measured?*

(a) Mill and others will measure the faculty or ability to

* Sir Josiah Stamp states that ability may be subject to five tests. "The problem of ability to pay might appear at first sight to be adequately dealt with by putting the question, 'How much have you

pay taxes by the *burden or sacrifice* involved in tax payments. See above.

✓ (b) Some suggest that faculty is to be measured by *consumption*. This view is not satisfactory because the consumption of the poorer classes is greater than their ability to pay and the consumption of the richest classes is less than their power to contribute to the state revenue.

✓ (c) Again other people suggest that *property* is the true measure of ability. The objection to this is that property differs greatly in productiveness, and that a man with a small property may have a large income and consequently great ability to bear taxation.

(d) Then there is the view that *income* is the best measure of ability. This is the view least open to objection and most widely accepted.

Of course income as a measure of ability is not completely satisfactory in every way. This is because "equal incomes are not equally permanent and so do not measure the same ability and also because of two persons with equal incomes one may have a larger family to support and so may have less ability to bear taxation.

It is impossible however to find a better single measure of

got coming in?' This I refer to as to the *Quantitative* aspect. But under the stress of modern high rates of taxation this can only be regarded as a beginning to a series of questions, and we must ask, 'Over what period?' A commercial traveller, for example, having had a fine week on the road, might be thinking only of his recent experience and answer, 'I am doing at the rate of a £1,000 a year.' This point must be dealt with under the heading the '*Time Element*.' Then follows the question, 'Are you sure it was pure income, without any wastage or return of capital?' which is a matter to be referred to hereafter as the '*Economic*' or '*Pure Income*' aspect. Even at this stage the true verdict as to comparative ability cannot be produced. We must ask, 'How do you get it?' because we want to know whether it has any reserve behind it, or whether its continuance depends entirely upon the continuance of the worker himself. This may be termed the '*Precarious*' or '*Earned*' income discrimination. Then follows the highly personal question, 'Are you free to spend it all how you like, or have you unescapable family claims upon you?' and to this aspect may be given the title '*Domestic Circumstances*.' Finally, there would be some who would ask, 'Did you get anything in excess of the sum required to induce you to give your service or lend your capital?' This may be called the '*Economic Surplus Distinction*.'

ability than income ; and the only course open to us is to levy taxes on income or revenue and in cases where it leads to injustice to remove the injustice either by varying the rate of the tax or by inheritance and other taxes and in other ways.

(iv) The general welfare theory.

What is a just tax? What is a just tax system for a country? My suggestion is that in this matter (as in all questions of Economics, and indeed of all social sciences) the answer is to be sought in the general welfare theory. What the state should take as taxation from each individual citizen and from all citizens should depend upon considerations of general welfare. Considerations of general welfare demand among other things that (a) in assessing and collecting a tax or taxes, the individual's economic minimum for a civilised physical and mental life should not be encroached upon and that injury to national production of wealth should be avoided as much as possible and that existing large inequalities of income and wealth should be decreased (b) in spending the tax revenue, the chief and exclusive aim should be the promotion of general welfare.

The faculty theory can be brought under this general welfare theory. Also the principles of least sacrifice and equal sacrifice.

Progressive and Proportional Taxation.*

If the rate of taxation remains the same for all incomes (or property) large or small, then we have *proportional taxation*. [When there is a proportional tax of 3 p. c. on incomes, then an income of Rs. 300 would pay Rs. 9 ($3 \times 3 = 9$) as taxes, an income of Rs. 500 would pay Rs. 15 ($5 \times 3 = 15$), an income of Rs. 1,000 would pay Rs. 30 ($10 \times 3 = 30$) and so on.]

* J. S. Mill was for proportional taxation in his *Principles of Political Economy* published in 1848; he suggested that a minimum of income necessary for physical existence should always be free from tax, and that earned incomes should be taxed at a lower rate than incomes from investments, for earned incomes would have to make provision for the future which was not necessary in the case of permanent income from investments.

If the rate of taxation increases as the income (or property) increases, then we have *progressive or graduated taxation*. [Suppose the rate of taxation is 3 p. c. for Rs. 100, 4 p. c. for Rs. 1,000 and above, 5 p. c. for Rs. 10,000 and above, and higher rates of taxation for larger incomes then we have progressive taxation].

We thus have *proportional and progressive taxation of income*; and also *proportional and progressive taxation of property*.

Justice in taxation is attained by levying taxes according to the faculty of tax-payers.

The faculty theory leads directly to the question of progressive and proportional taxation. *Now which is the better measure of faculty? A proportional rate of taxation or a progressive rate of taxation?*

Regressive and Degressive Taxation.

If the rate of taxation diminished as the income or property increases we have *regressive taxation*; and if the rate of taxes increases faster than the income or property but towards a fixed maximum rate, which it can never exceed, it is known as *degressive taxation*.

Arguments in favour of Progressive Taxation.

(Most economists are agreed that the *ability* of a person to pay taxes *increases more than in proportion to the increase of income or property*; and so following the ability theory, the rate of taxation should be higher for larger incomes or larger properties.) The *justice of progressive taxation* follows naturally from the ability or the faculty theory.

(Progressive Taxation gets strong theoretic support from the *marginal theory*.) "It was not until the marginal theory was thoroughly worked out on its psychological side that progressive taxation obtained a really secure basis in principle the principle is based upon the diminishing utility of money or wealth as a whole to its possessor."

(2) (Progressive taxation has also been defended on the ground that the larger the income the greater is its power for the production of further income.)

(3) Progressive taxation is justified by certain writers by reference to the "rental" conception in economic theory.

According to Mr. J. A. Hobson, the price or reward of a given factor in production, whether interest or wages, is fixed by the reward payable to the marginal supplier and the superior reward paid to a person with a position of advantage is in the nature of economic rent, and as its withdrawal would not lead to the withdrawal of the supply, it is capable of bearing taxation without further shifting. *This is Mr. Hobson's doctrine of the taxation of surplus*—costs cannot be taxed in theory and only the surplus (or the rent element in wages, interest and profit) can be taxed without further shifting. And Mr. Hobson assumes that these rental or surplus elements are more likely to exist in the incomes of larger amount and therefore progressive taxation of income is roughly taxation of surplus.

(4) (Progressive taxation has been also justified as an instrument for social improvement.

According to certain writers the present distribution of wealth is unfair to the mass of the people and the labouring classes; and the State by means of progressive taxation might make society better for the people at large than it is now, through increasing public expenditure on old age pensions etc.) In Prof. Marshall's words, the State is "to use its powers for prompting such economic and social adjustments as will make for the well-being of the people at large."

Arguments against progressive taxation (and in favour of proportional taxation); **and an examination of these arguments.** The opposition to the principle of progression is based partly upon an objection to the *principle of progression* and partly upon *administrative and other difficulties* connected with it.

(1) Some critics say that a progressive system of taxation with its higher rate for the upper classes is socialistic. They

maintain that progressive taxation seems to regard the existing system of the distribution of wealth as unjust while as a matter of fact, the existing system is just and should

not be disturbed. So the progressive system is wrong in principle.

(2) Even if it be admitted that the present system of the distribution of wealth is defective, the defects should be remedied not by taxation but by more direct methods dealing with the root causes of existing inequalities. Better educational facilities for the people, proper control of monopoly industries and a provision for wider industrial opportunities are much better instruments for removing the defects of the existing system of distribution than any system of progressive taxation.

And also wrong in its method.

Writers who do not regard progressive taxation as socialistic and who are not opposed to removing some parts of the existing inequalities by taxation, some of these writers point out other objections to the application of the progressive principle.

(3) *Progressive taxation*, it is maintained, *would check the accumulation of capital* and by checking the accumulation of capital would hamper production of wealth within the country. [The answer to this is that even a proportional tax will check, to some extent, the accumulation of capital; and hence this argument against progressive taxation is, more or less, an argument against all taxation in general. The argument is not therefore of much practical value.]

(4) *A progressive tax would be but slightly more productive of revenue than a proportional tax* and so there is no necessity for a progressive tax. (This is an argument used by some opponents of progressive taxation. The answer to this is (a) in many cases progressive taxation will mean a much larger revenue, (b) and even in that case where it is only slightly more productive than a proportional tax, yet it will fall to a greater extent on the richer classes and less on the poor classes and will thus secure a larger measure of justice for the masses).

(5) Another argument sometimes advanced in favour of proportional and against progressive taxation is that a *progres-*

sive tax would lead the richer classes to make false statements about their incomes so as to avoid the higher rate.

[The defenders of progressive taxation reply that persons who are capable of making false statements will attempt to evade proportional as well as progressive taxes and so the objection does not apply to progressive taxation alone.]

(6) Another argument put forward against progressive taxation and in favour of proportional taxation is that a *proportional tax is uniform whereas a progressive tax has a varying rate* and the variation of the rate is arbitrary and capricious. (We may answer to this, that all taxation is more or less arbitrary in this sense, the rate of taxation being fixed not by any natural law but being determined by the ethical judgment and the commonsense of the government.)

Conclusion on Progressive Taxation.

An examination of arguments advanced against progression thus shows that the objections against progression are far from decisive and indeed go to support the case in favour of progression. *The progressive system is not only theoretically just, it is practicable and its administrative difficulties are greatly exaggerated.*

A moderate degree of progression should be aimed at. Very high progression will be perhaps unjust, arouse great opposition from the rich and propertied classes, check the accumulation of capital, slacken the energies of industrial leaders and retard industrial progress. The progressive rates of taxation should never exceed (and perhaps should never reach) 100 p. c. on any part of income.

The subsistence minimum must be exempted from taxation.

The aim should be progression for the taxation system as a whole—stronger progression might be necessary in the case of one tax so as to counteract the injustice and injurious effects of other taxes.

The enormous expenditures of the last war have brought about a great extension of progressive taxation.

Why should the "rich pay more in taxes than the poor?" (C. U. 1930).

(The rich should pay more in taxes than the poor because they have greater ability (or faculty) to make contributions to the income of the state.) How is this faculty to be measured—according to burden or sacrifice, according to consumption or property or income? (Modern economic theory and the practice of nations agree that the best course open to us is to levy taxes on income or revenue and to supplement it by inheritance and other taxes and also by some taxes on consumption.) Refer to Vol. II, pages 450-464.

(The rich man's faculty to pay tax on income or property increases more than in proportion to the increase of income or property. So modern economic theory and practice are in support of progressive (not proportional) taxation of income or property.) Refer to Vol. II, pages 446-459.

(In modern countries progressive taxes on income and property (including death duties and inheritance taxes) follow the principle that the rich should pay more in taxes than the poor, as the rich have greater ability or faculty to pay. Taxes on necessaries (customs taxes for revenue or protective purposes, also internal taxes) impose heavier burdens on the poor than on the rich, for the poor spend a greater portion of their income on necessities than the rich. Such taxes go against the principle of the rich paying more in taxes than the poor, but they have been imposed in many countries to provide a sufficient revenue for the government. Such taxes, if very moderate in amount and not leading to the stinting of necessities by the poor will not lead to great hardship and injustice if they are balanced by substantially progressive taxes on the income and property of the rich.) Refer to Taxes on Income, Property (including death duties) and commodities.

Direct and Indirect Taxes.

(Direct taxes are taxes imposed by the state upon persons who are expected to bear the burden of these taxes and who are not expected to be able to shift the tax burdens to other

persons. In other words *in the case of a direct tax, the taxpayer is also the tax-bearer*) at least in the expectation of the lawgiver. (If the Government levies a tax upon the incomes of its servants and collects the tax by deducting it from salaries then the tax levied upon the Government officials is also ultimately paid by them. This tax upon the incomes of these officials cannot be shifted by them to other persons and so it is a direct tax)

(Indirect taxes are taxes which are imposed upon persons who are expected to shift the burden of the tax to other persons.

Suppose the Government imposes a tax upon books imported from abroad, and the book-sellers realise the tax which they pay to the Government by selling the books at higher prices to purchasers; then the tax on books is an indirect tax. The tax is first imposed upon the book-sellers but it is ultimately shifted by them to the book-buyers.)

The principal direct taxes are the land taxes, property taxes, poll taxes and income taxes; the indirect taxes are the custom duties, excise taxes, most fees and licenses.

Many writers doubt whether after all, the distinction between direct and indirect taxes is a real one, since many taxes which seem to be direct, at first sight, are regularly shifted to others.

Advantages and disadvantages of Direct Taxes.

(A) Advantages.

(i) Direct taxes are proportionate to income or property and in this way they are more *equitable* (just) than indirect taxes.

Also in the case of direct taxes alone, the important principle of graduation (progression) can be applied to income or property according to amount and source etc.

(ii) In rich and progressive modern states like Britain, direct taxes like the Income Tax (and the super-tax) and Death Duties (Inheritance Taxes) etc., are also very *productive*, and contribute the greater part of the total revenue of the nation.

Also the Income Tax introduces a very valuable and much-needed element of elasticity into the tax-system of the country.

(iii) Another advantage attaching to direct taxation is that it is *collected at the source* and so there is less chance of evasion.

(iv) The tax-payer also *knows definitely what he has to pay and when and why*.

So governments are compelled to be economical and careful. "If you had only direct taxes, you would have economical government" (Gladstone).

(B) Disadvantages.

(i) Direct taxes being directly paid by the tax-payers are more felt and so are more *unpopular* than indirect taxes.

(ii) Another difficulty is the necessity of assessment in all direct taxes. There must be a valuation of the object upon which it is charged and this affords opportunity for evasion on the part of the tax-payer and for arbitrary official action.

With the progress of society and education, people will come to see that direct taxation is really more just and economical than indirect taxation through increased price of commodities ; and then the unpopularity of direct taxation will decrease.

(iii) It is also sometimes said that direct taxation is not expansive and does not grow in proportion to the increase of national wealth. This is not correct, as the English income-tax has produced a large and expanding revenue.

*** Advantages and Disadvantages of Indirect Taxes.**

(A) Advantages.

Indirect taxes are strong exactly in those points in which the direct taxes are weak.

* After-war Problems.

Our Money and the State (Hartley Withers).

(i) Indirect taxes being paid indirectly by the tax-payers are not so much felt and therefore are more popular than direct taxes.

(ii) One advantage is that indirect taxes on commodities, etc., are paid by men when they spend, (not when they earn or save). So accumulation of capital is not discouraged.

(iii) Again indirect taxes on commodities are collected at a convenient time, since the tax-payer pays the tax when he buys the commodity: and he is at liberty to escape the tax by not buying the commodity.

(iv) In times of prosperity, indirect taxes are productive and elastic without pressing too heavily upon the people.

(v) It is important to have a broad basis for revenue by having indirect taxes in addition to the direct taxes. Under present conditions of public morality and social conscience, an excessive dependence upon direct taxes (like the income-tax etc.) may lead to extensive fraud and evasion.

(vi) It is also said that in a democratic country all classes should contribute to taxation; and as it is not easy to levy direct taxes upon the poor, the poor should be made to pay something by means of indirect taxes. Refer to pages 482-483.

(B) * Defects of Indirect Taxes.

(i) The greatest defect is that indirect taxes on articles of general consumption press more heavily upon the working

* "No system of taxation of commodities has yet succeeded in being properly progressive. Then it fails to do justice to personal obligations, and indeed does them an injustice; for the more claims a man has on him, through a large family, the greater is the tax to be paid, instead of the less. Again it makes no distinction between earnings and investment income, for if they are spent alike, they are taxed alike.

... Administrative difficulties introduce a second kind of regression. If the article taxed is one in general consumption, not only does the man who has the less real ability by reason of his family obligations tend to consume a larger quantity in proportion to his income, and, therefore, to pay a higher tax, but he also pays relatively more because he has an inferior quality. Most taxes have in practice to be specific and do not vary freely with the sale prices of an article . . . Must we conclude then that indirect taxation of commodities is inherently bad? If it existed by itself it would be very bad, but as a minor part of a

classes than on the richer classes, *this is not equitable*. The labourer has to spend a greater portion of his income on necessities than the rich man.

Indirect taxes on commodities (specially on necessities like food, drink, clothing, etc.) fall more heavily on the poor than on the rich partly because the poor man with his much smaller income has often to pay the same rate of tax as the rich man with his much larger income.

[This evil can however be diminished to some extent by taxing articles of general consumption and by levying higher duties upon superior qualities of the articles taxed.]

(ii) At times of depression the revenue from indirect taxes often shrinks.

(iii) Increased rates sometimes produce stationary or even diminished receipts.

(iv) Expenses of collection are sometimes larger in the case of indirect taxes than in the case of direct taxes.

(v) Often a serious objection to the indirect taxation of commodities is the loss to society through the disturbance of industry. This evil can be reduced to an important extent by suitable regulations and precautions.

An examination of the merits and defects of direct and indirect taxes shows that *in future direct taxes should form a predominant part of every well-organised tax system—direct taxes consisting of the income-tax in its various forms, death duties, legacy duties, etc. Indirect taxes also have to be included in every tax-system along with direct taxes. But reliance on indirect taxation to a great extent will be unjust to the poorer classes and at times of depression will cause serious financial difficulties.*

As a matter of fact, in rich and progressive countries like England, indirect taxes on account of their heavy burden on the poorer classes and other defects are being replaced more

general scheme, carefully watched, it can be made to conform roughly to the principle of ability, over an area which, though rightly taxable, cannot be properly reached by direct taxation."

Stamp—*Fundamental Principles of Taxation.*

and more by direct taxes. In 1873 indirect taxes produced about three-fourths (73 per cent.) of the total tax revenue of England: and in 1916-1917, they were expected to yield 34·6 per cent. only, the remaining 65·4 per cent. being produced by direct taxes.

The Indian Tax system is unsatisfactory—there is too little of direct taxation and the richer classes do not pay their fair share of the tax-burden, there should be more of direct taxation in the form of higher income tax and super-tax and higher inheritance taxes; there is too much of taxation of commodities (indirect taxation) as compared with direct taxation of income and inheritance, and so the poor have to pay more than their fair share of the tax burden. If with the introduction of protection in India, indirect taxation is further increased, justice demands that there should be a compensating increase of direct taxation; and the increased revenue of the state should be used largely for educational and public health expenditure for the benefit of the masses of the people.

Some Indirect Taxes—Customs Taxes and Internal Taxes (Internal Revenue Duties) on Commodities. *Excise Taxes, Sugar & Ammonia 5:4*

Custom taxes.

(Customs duties are taxes imposed upon commodities when they cross the boundaries of a state or of a customs union (composed of two or more states).)

Customs taxes are of two kinds:

- (1) *Protective customs duties* (2) *Revenue duties.*

Protective customs duties are taxes levied upon imported foreign goods primarily with the object of diminishing foreign competition with a corresponding domestic industry. A country imposing protective customs duties is said to have a *protective tariff*. *Revenue duties* are customs duties which are imposed primarily for securing a revenue for the Government and not for protecting domestic industry. A country imposing only revenue duties is said to have a *revenue tariff*. All large and powerful modern countries Britain with British India and

British colonies, France, Germany, Russia and the United States, etc., have got protective tariffs.

There is a fundamental opposition between revenue and protective principles. For a duty to be adequately protective must largely shut out foreign imports and then very little revenue will be raised by such a duty. (The tariff of a country does often contain some protective duties and some duties which are mainly for revenue. This is the case in the United States and also in many other protectionist countries).

Some of the most *useful qualities in custom duties* are (1) high productivity (2) cheapness of collection (3) stability and responsiveness to the control of the treasury. These virtues are to be found in a larger measure in revenue duties properly selected than in a comprehensive and complicated system of protectionist duties.

[Duties levied upon the value of the imported commodities are known as *ad valorem*; duties levied according to weight, bulk or other units of measurement (and not according to value) are known as *specific duties*. Obviously specific duties fall most heavily upon the coarser or cheaper grades of commodities. *Ad valorem* duties are however open to the objection that they offer a greater temptation to business men to make fraudulent valuation and thus to evade a part of the taxation.]

Internal revenue duties.

Internal revenue duties largely consist of excises. Excises may be defined as taxes levied on commodities produced within the country and destined for home consumption.

(1) Defects.

Excise taxes suffer from the following defects:—

(I) As these taxes are levied generally on articles of general consumption consumed even by the masses of the people, and as they are shifted in a large degree to the consumers, these taxes frequently weigh more heavily upon the poor than upon the rich. This is unjust.

(II) Another defect of these duties is, that in some cases they involve detailed supervision and interference with the taxed industry and this is unpopular.

(III) Excises taxes often exercise little beneficial influence upon the consumption of articles, the use of which is believed to be harmful to the consumer. This is because a high excise tax upon such commodities will often lead to adulteration instead of high price and diminished consumption.

Merits.

Internal revenue duties if properly selected have the following advantages: (1) They are highly productive (2) and they have a considerable amount of elasticity in rich and progressive countries. (3) The expense of collection is small. (4) The burden of internal revenue duties is generally shared between the producer and the consumer. (It must be remarked here that these duties are productive and elastic only in rich and progressive countries. In a poor country and during a time of depression, these duties will neither be highly elastic nor highly productive).

Taxation of Commodities.

Taxes on commodities are indirect taxes, and they have the usual defects of indirect taxes.

In a country taxes on commodities are imposed in the form of (a) customs taxes on imported and exported commodities (b) in the form of internal taxes (or revenue duties) on the consumption and on the production of commodities within the country.

In levying custom or excise or other taxes on commodities, the general principles already discussed (*pages 434-437*) should be borne in mind.

(I) The taxation of *necessaries* should be avoided as far as possible as such taxation weighs very heavily and unjustly upon the poorer classes. When the need for revenue is very great, taxation of necessities cannot be avoided; but to secure an equitable distribution, heavy taxes on the luxuries of the

rich should be imposed at the same time. A prominent example of taxation of necessities consists in food taxes.

Food Taxes.

Taxes on the food of the people are (1) bad from the moral standpoint because such taxes impose a cruel burden on the poorest classes (2) bad from the economic and financial standpoints because these taxes lead to starvation, underfeeding, and thus to economic inefficiency and disease specially among the lower grades of workmen, increase of the pauper population and higher taxes to maintain them.

So taxes on food must be always avoided, if possible. Food taxes, bad as they are, have to be levied often in war time when the need for revenue is extremely urgent and also in very poor countries where the required revenue cannot be raised otherwise.

(II) *As taxation of necessities is to be avoided as far as possible, it was proposed to levy special taxation on the luxury commodities during the last war,—the great need of revenue, the shortage of necessities and the importance of discouraging luxury and encouraging saving led to strenuous attempts in many countries for the taxation of all kinds of luxury expenditure. But the difficulties of defining luxury and administration of luxury taxation led to the abandonment of schemes of luxury taxation in Britain and in France.*

Taxation of *harmful luxuries* and other *injurious articles of consumption* (e.g., alcohol, opium) is generally advocated on the ground that such taxation will check harmful consumption and will at the same time secure a revenue for the Government.

(III) As far as possible the taxation of *commodities, the demand for which is elastic*, should be avoided. Taxation of such commodities brings about a large contraction of demand and a large loss of consumer's surplus to the people.

These are the points to be taken into consideration from the standpoint of consumption.

(IV) The taxation of raw materials, *i.e.*, cotton, jute, wool, etc. is injurious because (1) by adding to the cost of the raw

material it may check the development of the manufacturing industries (2) by adding to the cost of the raw material, it increases the price of the manufactured product to the consumers.

(V) *The taxation of developing industries producing commodities subject to increasing returns* is undesirable (and is to be avoided as much as possible) as such taxation will make the people miss the advantages of increasing returns and will increase the prices to the consumers.

(VI) *Commodities* the supply of which is *monopolised* are fit subjects for taxation because such taxation will generally fall on the profits of the monopolist. (A lump sum tax on a monopoly and also a tax proportionate to the monopoly revenue are paid by the monopolist out of his own monopoly profits; and the consumers escape the tax. Refer to pages 468-469).

(VII) *Import duties* are most profitably imposed on commodities for which the country has a monopoly of demand or the production of which is monopolised or is subject to increasing returns in the foreign country producing the commodity. In these circumstances a part or the whole of such duties would be paid by the foreign country.

(VIII) *Export duties* are best levied on commodities of which the exporting country has got a monopoly of supply. A good example is jute exported from India. Export duties in such cases will be paid by the foreigners to whose countries the commodities are exported.

Some Direct Taxes—General Property Tax, Income Tax, Inheritance Tax and Death Duties etc.

General Property Tax.

A general property tax is a tax which is levied on the entire amount of the property, real and personal, owned by the payer. It is used in Russia, Holland, Switzerland but it is used more extensively in the United States than in any other country. The general property tax has been universally condemned in the United States and this condemnation is chiefly due to the fact that it is not properly supplemented by other taxes.

One great method of direct taxation in modern times is the Income Tax.

The income-tax is based upon the income of the tax-payer. We have the income tax in England, India, Italy, in the German States, Austria and Switzerland; and income taxes have been introduced also in the United States and France.

* The ideal income tax (a) should exempt all savings from taxation—for savings form the source of future capital, and property is to be taxed by taxes on inheritance and in other ways, and (b) should be properly graduated according to faculty—small incomes must be exempted, moderate incomes are to be taxed at moderate rates, and large incomes at higher rates. The tax should be graduated also according to the number of dependents upon each income.

In practice, the Income Tax in Britain and also in India does not exempt savings except chiefly in the form of life insurance, and *the Income Tax in Britain as also in India is graduated* according to faculty; and in addition there is a super-tax on higher incomes in both countries, but the graduation is higher and fairer in Britain than in India.

The British Income Tax is also graduated according to the number of dependents upon each income. This is not the case with the Indian Income Tax.

* Mr. Hartley Withers waxes enthusiastic over an ideal income tax. "And since we are only chasing the rainbow of the ideal, we may also add that in order to make the income tax perfect, it would, though assessed on the whole income, only be imposed on that part of a man's income which he spends, and he would be allowed abatement in consideration of any part of it that he invested and not only, as now . . . in life insurance" (*Our Money and the State*).

Professor Marshall offers the following remarks on an ideal income tax: "If it were possible to except from the income-tax that part of income which is saved, to become the source of future capital, while leaving property to be taxed on inheritance and in some other ways then an income-tax graduated with reference to its amount, and the number of people who depended for support on each income, would achieve the apparently impossible result of being a graduated tax on all personal expenditure. . . The way to this ideal perfection is difficult; but it is more clearly marked than in regard to most Utopian goals."—*Afterwar Problems*.

In most countries *earned income* are charged at slightly lower rates than incomes from investment; in Britain earned incomes do not pay a lower rate but there is an additional 10 per cent. exempted from taxation with a maximum exemption of £200.

As regards the *minimum income exempted from taxation* the American minimum amounts to 1,000 dollars for the unmarried man and 2,000 dollars for the married and the English minimum is lower amounting to £150 per year for the unmarried man and £225 per year for the married just covering physical necessities; the Indian minimum exempted from taxation is lower still and does not cover adequately even physical necessities.

Exemptions from the income-tax.

Small incomes are generally exempted from the income tax (a) partly because the possessors of such incomes pay their due share and even more than that through other taxes (b) partly because the expenses of collection would be disproportionately high and also the unpopularity of the tax would be very great among the poorest classes.

Double taxation under the income-tax.

It is maintained that a man has often to pay double taxation under the income-tax. Suppose a man has an annual income of £1,000 on which he pays an income-tax; and out of his income of £1,000, he saves £300 and gets an annual dividend of £30 from his £300 savings, and has to pay income-tax upon this £30 also. Then he has practically to pay double taxation upon the income which he gets from his savings.

† The distinction between earned and unearned income is to be clearly understood. In Britain '*unearned*' income is that income which rises from capital resources and is thus more permanent than the income earned by labour of any kind. "It is the presence or absence of capital resources that warrants the whole distinction for taxation purposes. It was long ago recognised that £100 from toil was weaker than £100 from dividends, because the toiler has to make provision for precariousness of employment, sickness, old age, and other infirmities, and also because he is tied and often has to incur extra expenditure through living near his work and being unable to select his abode very widely."

* "An alternative method would be, of course, to exempt the income derived from savings, at any rate during the life-time of the saver, and this might appear to be more logical than exempting the amount of income saved."

Merits of the Income Tax.

An income-tax has the following merits.

(1) It is *fair and equitable*. We can measure ability better by income than by wealth or consumption or any other single standard.

(2) It is *productive*; and experience has shown that it *gains in economy and productiveness* and becomes more and more popular as the years pass on.

(3) It *cannot be shifted* easily if at all, and so there is little trouble due to shifting.

(4) A most useful feature of this tax is its admirable *elasticity*.

In good times when the customs and excise taxes are productive, a reduction in the rate of the income-tax will enable the Government to avoid an excessive surplus. At times of depression when the revenue from other taxes falls off, a rise in the rate of the income-tax will enable the Government to increase its revenue to the required extent with a minimum disturbance of industry and capital.

This elasticity makes the income-tax admirably fitted for the position of the central tax of the revenue system and its regulator. And this is the function performed by the income-tax in England.

Disadvantages.

The income-tax has, however, certain disadvantages.

(1) It is generally *unpopular, specially when it is first introduced*. People do not like the searching enquiries which are necessary to ascertain the income upon which the tax should be assessed.

* Sir Josiah Stamp—*Fundamental Principles of Taxation*.

(2) Another objection to the income-tax relates to *difficulties in its administration*. In calculating the net income upon which the tax is to be imposed, a large number of deductions have generally to be made from the gross income; and there are practical difficulties in determining the amount and the kind of these deductions.

The income-tax has great and outstanding merits and these disadvantages are of a comparatively minor character. And a suitable income-tax carefully framed so as to minimise the disadvantages should form a part and an important part of the tax system of every country.

Inheritance Taxes and Death Duties.

The second great method of direct taxation in modern times is the taxation of property passing at death.

A favourite and very productive form of taxation in recent years is the taxation of inheritances, collateral or direct. The usual practice is (a) to tax bequests to the distant relations at higher rates, and also (b) to make the rate high for large and small for small inheritances.

Merits.

The inheritance tax has the following merits:

(1) It is in conformity with the ability or faculty theory. A man's ability to pay taxes is obviously increased when he inherits property; and the larger the inheritance the greater is the ability.

(2) Such a tax is easily collected, and without much expense.

(3) Income Taxes as well as Inheritance Taxes are both likely to come, to some extent, out of potential capital. As compared with Income Tax, Inheritance Tax has the advantage that it leaves a man his wealth during his life and it also allows him the prestige of leaving large sums at his death and being a deferred tax to be paid on death is likely to be less unpopular than a high income-tax.

Examples of taxation of property at death are found in the *Death Duties (Including Estate, Legacy and Succession*

Duties) in Britain and the Inheritance Taxes in the United States of America. Taxes of this kind may vary (i) with the size of the estate (ii) with the degree of relationship of the heirs to the testator or (iii) with the amount inherited by each individual heir.

In the English system, the Estate Duty (which is graduated from 1—40 per cent.) varies with the value of the estate left, the Legacy and Succession Duties (which are graduated from 1—10 per cent.) vary with the degree of relationship. In the American Federal Inheritance Tax, the graduation is based on the value of the estate ; and in many of the American State (or Provincial) taxes and in the French tax, the graduation is in part, at least, based on the amount inherited by each individual heir.

A progressive inheritance tax has been introduced in England. A high degree of progression is advocated by reformers. Bequest to distant relatives seems to be a survival of the sentiment of past times when even distant kinship was a stronger bond than common citizenship in a city or a state. Such sentiment is now declining in force and intensity ; and there is every likelihood that bequests to distant relations will be largely curtailed by modern legislation and in favour of the state.

In England, after the war, an increase of inheritance taxes became necessary and also desirable. And a progressive tax on inheritances is wanted in India to lighten in some measure the burden of taxation on the poorer classes.

(For **Income and Inheritance taxes** refer to the Colwyn Report, pages 108-198 and also pages 462-464 of Vol. II of this book).

Poll Taxes.

(Poll taxes are direct taxes which are usually imposed at a uniform rate upon all male citizens.

Such a tax bears more heavily upon the poor than upon the rich and is thus inequitable ; and it is difficult of collection and generally very unpopular. For these reasons, poll taxes are disappearing from the tax systems of modern states.)

The Taxation of Surplus.

There is the danger that graduated taxes on income and inheritance (with substantially higher rates for higher incomes and also for larger inheritances), may check to some extent accumulation of capital and production of wealth in a country.

But taxation of surplus (*i.e.*, income which is not the result of any useful economic service and is therefore not necessary to maintain the supply of such service)* will not affect production of national wealth.

Taxation of unimproved land value.

The value of unimproved land near a town depends upon the growth of the town and not upon any work or capital put into it by the owner of the land.

A tax on this unimproved land value will not reduce the supply of land, will not affect production, such a tax will reduce only the income of the land-owner from the land—and therefore it is a suitable tax from the national standpoint.

The objections to a tax of this kind are the following :

(1) It is not always easy to distinguish between that part of the value of land which is 'unimproved,' and the part which is due to improvements ; and taxes on improvements will check production.

(2) To put a special tax on land is to put a special tax upon one kind of investment, thus making a sort of unfair discrimination against it as compared with other investments.

Taxation of Increment Values.

But there is no unfair discrimination against one kind of investment, if it can be shown that this kind of investment has enjoyed and is enjoying special good fortune. Suppose a man purchases land, he finds after a dozen years that a factory town has spread in the direction of his land and has given his land a great increment of value ; now *he has got this increment of value as regards his land by special good luck* (and not by any effort of his own) and *so it is fair that he should pay a special tax on this increment value.*

If the whole of the increment value is not due to luck or good fortune, but a part of the increment value has been calculated beforehand by the owner of the land who has spent some effort and capital for this purpose—then some allowance must be made for this.

In Germany, there is taxation of increment values ; in Britain such taxation was introduced before the last war, but it was abandoned in 1920.

Incidence of Taxation.

To understand the subject of incidence, we must distinguish between the *incidence* and the *impact* of a tax. The *impact* of a tax is upon the person from whom the tax is *first* collected, and the *incidence* upon the person who pays it *ultimately*.

Suppose a tax is imposed upon a commodity imported from a foreign country. The government will collect the tax from the foreigner, but the foreigner will generally raise the price of his commodity on account of the tax, and in some cases will recover the whole amount of the tax from the domestic consumer. In these cases, the incidence of the tax is upon the domestic consumer who ultimately pays the tax.)

By the term *shifting* is meant the transference of the burden of a tax from the payer to some other person or persons. In the case mentioned above, the tax is said to be shifted to the consumer from the foreigner who pays the tax at first. The process of shifting is also called repercussion* of taxes.

The subject of shifting is a very important one ; and statesmen and financiers have to be particularly careful that their object in framing a tax system and their attempt to establish justice in taxation are not frustrated by the shifting of the taxes they impose.

Elasticity of supply.

The chief actor controlling the incidence and the shifting of taxes is mobility or elasticity of supply ; and this mobility depends upon the scope of the tax, upon the existence or non-existence of monopoly or differential advantages.

A tax universal in scope cannot be easily shifted. A tax levied upon mortgages within one particular area can be shifted by the mortgagee because he can invest his capital in other ways and thus can escape taxation.

Incidence of different kinds of taxes.

1. *Taxes on economic rent and other differential advantages.*

Land (specially in an old, thickly inhabited country) is inelastic in supply. Incidence of taxes on pure economic rents fall upon persons who receive the rents. This applies to economic rent of land and to all true rents including personal rent.

Economic rent does not enter into cost of production (and price) of the commodity, and a tax on economic rent cannot be shifted to purchasers of the commodity.

2. *Tax on interest.*

(a) *Tax on interest in general.*

If interest in general is taxed, then the net yield of capital is diminished. The reduction in the net yield of capital in a country discourages the accumulation of capital in that country, capital is elastic in supply; and it also leads to the exportation of capital to other countries where the net yield is higher. This check to the supply of capital in the country raises the marginal utility of the capital and thus raises the rate of interest. The tax on interest is thus shifted to the borrower by the elasticity in the supply of capital.

(b) *Tax upon particular forms of interest.*

If a tax is levied upon interest on mortgages and not upon other kinds of interest and if the tax is imposed upon the lender, he will easily shift it to the borrower. The lender can evade the tax on mortgage interest by lending in other ways and so here the borrower will have to pay the tax,—the incidence of the tax will be upon the borrower.

3. *A tax on buildings.*

If the supply of houses is larger than the demand, the incidence of a tax on buildings will be on the owners of these

houses. When the supply of houses is limited, then the owner will be able to shift the tax to the tenant.

4. *Wages taxes.*

A tax on wages generally falls on the workmen, specially if the wages are high. If the tax affects the efficiency or supply of labour, then the wage-earners will be able to shift a part or the whole of the tax to the profits of the employers or to consumers in the form of increased prices.

5. *Tax on profits.*

A tax on profits, if extending to all profits, will be generally borne by the producers. A tax on profits, if confined to the profits of some particular occupation, will be borne by the consumer.

6. *Income-tax.*

A general income-tax consists of a combination of taxes on the separate ingredients of income—rent, interest, profits, and wages; and the incidence of the income-tax must depend on the laws applicable to each separate part.

7. *Customs duties (import taxes) and excise taxes.*

The incidence of excise taxes and import taxes is generally upon the consumer. These are sometimes shifted to the producers (1) if the taxed commodity is produced as a monopoly and the price is already as high as the traffic will bear (2) if a new tax is levied on some commodity produced by a large plant.

8. *Taxes upon monopolies.*

(i) *A fixed (lump sum) tax upon a monopoly* and (ii) *also a tax proportioned to the monopoly revenue, rest upon the monopolists*, (unless the tax is so high as to reduce the monopoly profits below the amount that can be earned in a competitive industry). Such taxes cannot be shifted to purchasers of the commodity because the monopolist cannot alter the supply—he has already fixed his production at the amount which gives him a maximum gain and an alteration in the supply (and price) will reduce his net gain.

(iii) *A tax in proportion to the amount produced by the*

monopolist can be shifted by him by reducing the supply. As the tax is proportioned to the supply, a reduction of supply will involve reduction in the amount of the tax paid by the monopolist.

Are old taxes the best taxes?

It is sometimes said that old taxes are the best taxes. Now as a matter of fact, *old taxes are not always the best taxes.*—heavy taxes on the food of the people or unwise protectionist duties are *bad taxes* whether they are old or new. Bad taxes do not become good only because they have grown old.

Old taxes have however certain advantages—they have become less unpopular as the people have grown accustomed to them, perhaps the injuries caused by them have been diffused among the people and in some cases the capitalisation of a tax may have removed the burden altogether.

Amortisation.

(Amortisation of a tax means its capitalisation—in a case of amortisation the property taxed has its value depreciated by the capital value of the tax.)

PUBLIC DEBTS.

The Public Debt.

All large modern states have got large national debts, contracted (1) chiefly on account of wars and (2) partly on account of extraordinary expenditures in connection with public works and public industries.

Modern states have large public debts. The national governments of the civilised world owed in 1908-1909 the huge total of 7500 million sterling (£7,500,000,000). This huge total has been multiplied many times by the enormous expenditures of different nations in the last world war; and problems relating to the public debts of nations are engaging the serious attention of nations and their governments.

In primitive society where commerce is small and manufacture scanty, governments make provision for future emergencies by hoarding from surplus

State borrowing has replaced the earlier system of hoarding by the state for special emergencies.

revenue and not by borrowing from the people. These early governments have hoarded state treasures and they have no national debts. The growth of manufactures and commerce and the development of credit make it possible for a government to meet special emergencies like wars, etc., by borrowing from the public and thus the system of national debts comes into existence. Prof. Bastable has shown how this development goes hand in hand with the development of constitutional government.

Present theory.

Present theory does not regard public debts as inexhaustible mines of gold to be exploited at pleasure, nor does it condemn all public debts with indiscriminate censure. It recognises that *in modern states, within certain limits, public debts are necessary and also desirable*. Now what are these limits?

The present financial theory is that (a) the *ordinary expenditures* of a state (those expenditures,

The state should be allowed to contract public debts (1) for special emergencies like wars (2) for public works and (3) for a temporary necessity.

which recur with sufficient regularity, so that they can be foreseen and estimated in advance) *are to be met from the ordinary revenues* which include receipts from public domain, public industries, fees, taxation,—or the state will become bankrupt (b) and that the state should be allowed to meet *extraordinary expenditures* in connection with (1) special emergencies like wars (2) productive public works, e.g., state railways, irrigation works, municipal gas works, water works, etc., from loans. *War expenditures may be met partly from taxes and partly from loans but expenditures on productive public works should be from loans only, and not from taxes*—taxation for this purpose would mean an unnecessarily high level of taxation and would not be generally justified. (3) The state may also borrow to meet a temporary necessity

as when there is a deficit in the budget, the revenue of the year falling short of the expenditures for that year.

It is clear what kind of expenditure is to be provided for by public borrowing and what kind of expenditure is to be defrayed from the ordinary revenues. And normally taxes should not be so heavy that they cannot be paid easily out of the annual income of the nation. If taxes have to be paid from the national capital, they will disturb and disorganize industries. The state may borrow capital from its subjects to meet its own needs but this it should do by borrowing the national uninvested capital and not by taxing invested capital and disturbing industries.

The different forms of Public Debt. 139

The two important forms of the Public Debt are :

(A) The temporary, *floating (or unfunded) debt* which is an advance to the government repayable by the government on the demand of the creditor, or within a comparatively short period.

Floating debts suffer from two disadvantages—(a) they exercise a disturbing influence on the money market (b) they are a source of embarrassment to the government because it is precisely at a time of difficulty that the strongest demand for repayment is likely to be made.

It is therefore an established financial maxim that the amount of a floating debt should be kept within narrow limits.

(B) *The perpetual debt* which is contracted without any date for repayment but repayable at any time at the pleasure of the government. It is in this shape that a great part of the debt of England, France, Italy and the German state exists.

The system of perpetual debt offers many important advantages to a government.

(i) The borrowing state is relieved from the risk of a sudden demand for the repayment of capital and has only to provide for the periodical payment of the interest on the capital.

(ii) The state again is always able under this system to reduce as much of the debt as it wishes and has the power to repay and at the time most convenient to itself.

The creditor is also under no serious disadvantage because at any time he can realise the capital value of his loan by selling his stock in the stock market.

(C) *Other miscellaneous forms of Public Debts.*

Another classification of the Public Debts divides public loans into two classes (1) forced or compulsory loans, (2) voluntary loans on business principles.

Compulsory loans were favourite devices with sovereigns in earlier times. The injustice and the inconvenience attaching to forced loans ought to exclude them from the list of fiscal expedients to be allowed in a modern state. In modern states, voluntary loans issued on business principles constitute the only eligible method for raising funds by borrowing.

Issue of a Public Debt.

The following considerations are to be borne in mind by the financier when he is going to issue a public loan.

(A) He will have to consider carefully the objections against public borrowing so that he might see whether he is justified under the circumstances of the case in disregarding these objections and issuing a loan. (a) *And he should attempt to raise his loan in a way so to avoid as much as possible the evils attaching to public borrowing.*

Objections to public borrowing.

The weight of objections to public borrowing largely depends upon the purposes for which the money is borrowed. If the borrowing is for extravagant, wasteful expenditure or for the ordinary annual expenses of the government, then borrowing is not justified; and if it is for proper objects (*i.e.*, for necessary expenditure on wars, on public works or for a temporary necessity) then *prima facie* it is justified.

Some objections to public borrowing are based on their political, and economic effects.

(1) *Political.*

(a) The result of borrowing is to conceal from the nation the full financial effects of the policy of the government. Taxation instead of borrowing would make the effects quite clear to the people by increasing heavily the tax burden.

[In connection with this, it may be pointed out that after a certain point, increased taxation is impossible and the state has no other alternative but to borrow to meet its expenses. And if the state borrows for proper objects and purposes, it is justified.]

(b) In the case of weak states, the political status of the state may be endangered by the contraction of foreign loans. This has been the unhappy experience of many states in Asia.

(2) *Economic.*

Public loans may divert capital from productive industries and thus injuriously affect the industrial future of the country. (When there is a war, entailing enormous expenditures, the revenue from taxation should be increased to the highest limit to which it can be raised without prejudicing industry; and in this way a part of the extraordinary expenditure is met from additional taxation and then loans should be raised to defray the rest of the war expenditure and *steps should be taken as far as possible to see that the loans take national uninvested capital and do not divert capital from productive industries.* In this way the objection from the economic and industrial point of view may be to some extent met).

The financier has to be careful also about the *manner* in which the debt is to be contracted.

(i) It has been seen that floating debts disturb the money market and also are inconvenient for the government in certain respects, so floating debts should be kept as small as possible, and the government should depend mainly upon the funded debt. (ii) The debt should be also in a varied form so as to suit the needs of different classes of investors.

Loans Versus Taxes during a war.

Ricardo maintained that war expenditure should be met entirely from taxation (not from loans), Pierson has held the view that war expenditure should be met from loans (and not from taxes)—but the last world war has shown conclusively that *for a big war under modern conditions, governments have to borrow and also to increase taxation,*

During the course of a great national war, taxation should be largely increased for in such a time (a) taxation is easily raised with the help of patriotic motives (b) taxation at such a time is little if any hindrance to industry, and (c) it exercises a most beneficial effect by checking the consumption of the individual.

The citizen economises and the government gets its revenue—so taxation in war time is twice blessed. (*Withers*).

Conversion of Public Debts.

The process of conversion consists in converting or altering a loan bearing a given rate of interest into a loan at a lower rate of interest. Several important examples of conversion are to be found in the financial history of England, France, and the United States.

The state carries out the conversion of the debt by offering its creditors the choice of repayment or of new securities at a lower rate of interest.

Advantages.

(A) This reduction in the rate of interest by conversion is *fair to the creditors* for the creditors are allowed the alternative of getting back the principal of the debt.

(B) And the advantage of conversion to the tax-payers is that it *reduces the burden of interest to be paid by the state and relieves the tax-payers*. The finance minister as the guardian of the interests of tax-payers should always be on the look-out to see whether conversion is possible and when it is possible, he should carry it out to relieve the tax-payers' burden as far as possible.

Certain general considerations should guide the finance minister in his work of conversion.

(1) Conversion can be successfully carried out when the credit of the Government is good. Punctual payment of interest on the public debt by the Government, suitable provisions for debt redemption and generally speaking efficient management of the debt improve the credit of the Government and make conversion possible. Some other rules laid down by financiers are—

(2) The beginning of a period of prosperity is often the best time for a conversion because then the rate of interest is low.

(3) The scheme should be made simple so that it will be readily understood by the people and the conversion will thus be made successful.

The funds set free by conversion can be applied for the remission of taxation or for the redemption of debt.

Redemption of the debt. 139

Generally speaking the redemption of the public debt is desirable. As the state borrows money under great pressure and generally when it finds itself unable to raise funds by the agency of taxation, it is clear that the debt should not be made a permanent one and attempts should be made to redeem the debt at the earliest opportunity.

The subject of redemption may be considered under the three following heads—

(1) *Redemption of the floating debt.*

This is eminently desirable. A large floating debt disturbs the money market and is a source of embarrassment to the government. And when redemption is not possible, the greater part of it should be converted into funded debt.

(2) *Redemption of debts contracted for productive public works.*

Every productive public work (e.g., a municipal telephone system or a municipal tramway or a municipal water-supply system) has a limited life, will last for a number of years and produce an income during these years. The redemption of the debt contracted for a productive public work should be carried out within the period during which the public work will produce its revenue; otherwise the future generation will be burdened with more than their just shares of the public debts.

(3) *Redemption of funded debt including non-productive debt.*

The general argument in favour of redemption of debt is this: Redemption is desirable because—

(1) Each period of national history has its own financial burdens to meet and the neglect of repayment in the present may increase dangerously the burden of debt for the future generations.

(2) The repayment of debt if properly carried out and if its amount is kept within the bounds set by the extent of suitable taxation will not press heavily upon tax-payers and will not weaken national power.

(3) Another advantage is that repayment of debt improves public credit and makes possible lowering the rate of interest on public loans and thus afford means for reducing taxation.

[The general proposition that redemption of public debt is desirable does not apply to the following exceptional cases.

(1) During a war with its heavy financial burden, the repayment of public debt must obviously be stopped.

(2) Again when the burden of taxation is excessively heavy in a country, it is better to reduce taxation and to relieve industry and trade than to continue the work of redemption of public debt.]

Burden of external debt and of internal debt.

Refer to pages 480-481 of this book.

1. The Sinking Fund.

The sinking fund is a fund accumulated for the redemption of the debt. It may be an annual fund (that is a portion of the annual income) or it is the accumulated capital from one or more sources for repayment of the debt. When a government is embarrassed for money and has to stop the work of redemption for a time, the sinking fund is suspended.

2. A Capital Levy.

It has been proposed to repay the whole (or great part) of the enormous war debts of the last great war by means of a big levy on capital. This subject has been widely and exhaustively discussed in Germany and Austria, in Britain, Italy and the United States.

Those who are for this capital levy maintain that this levy on property (1) is necessary (for taxes on income alone are insufficient to pay for the war, also excessively heavy income taxes will injure production and saving), (2) is just (for it will fall chiefly on old men who have much property but are exempt from military service—the young men have fought for the state, let the old men pay for it).

Those who are against the capital levy declare that such a tax on property would disorganise business, discourage saving, encourage public extravagance and would "descend with crushing burden and cruel inequality."

The situation is not the same in all countries—and indeed the same argument may have a different weight in different countries.

The Colwyn Report in definitely against the capital levy. Refer to page .. of this book.

At present, no country has yet practically carried out this capital

levy.
3. *Scheme of Conversion of old bonds to new ones.*

Financial Administration—The National Budget.

The national budget is a statement of the nation's accounts (of revenues and expenditures) for the year. In opening his budget, the finance minister gives the complete accounts of the past financial year with its actual revenues and expenditures and also the surplus or deficit if any; and he estimates the expenditures for the coming year, and provides the 'ways and means' required—the ways and means include taxes, also all other kinds of revenue from public domains, public industries, etc.

The budget should be prepared annually. If the period is less than a year, then too much time would be spent in the preparation of budgets; and the period should not be too long, it should not be more

than a year—for then the making of proper and accurate estimates would not be possible.

Summary.

1. Public Finance deals with the revenues and expenditures of Governments.

2. The subject of Public Finance is of great and increasing importance on account of the enormous aggregates of public revenues and expenditures in modern states, and because of the great influence exercised by it on production, consumption and distribution.

3. The object of public expenditure is general welfare—the creation of maximum utility for the people. Public expenditures in modern states are rapidly increasing on account of the growth of population and the gradual extension of government activity.

4. The chief forms of public revenue are revenues from domains, revenues from public industries, fees, taxes, and extraordinary revenues (i.e., loans). Taxes form the most important source of revenue in modern states, and they are compulsory payments for government expenses.

5. Justice in taxation is secured by following the faculty theory and taxing persons according to their ability to pay—or by following the general welfare theory.

6. The six canons of taxation are (1) sufficiency (2) equity (3) economy (4) certainty (5) variety (6) flexibility.

7. Those who advocate *proportional taxation* declare that progressive taxation is socialistic, is wrong in its method of rectifying social inequalities, that it checks the accumulation of capital, leads to evasion, is arbitrary and is only slightly more productive than proportional taxation. The advocates of *progressive taxation* point out that most of the arguments against progressive taxation possess little weight, and that progressive taxation is a better measure of faculty than proportional taxation.

8. The advantages of *direct taxes* are that they are collected at the source and cannot be evaded, are more equitable than indirect taxes and the tax-payers know how much they have to pay; the disadvantages relate to assessment and also to their unpopularity. The advantages of *indirect taxes* are that they are more popular than direct taxes, they are exacted at a convenient time, and that even the poorest class can be made to contribute; the defects are that these taxes are not equitable, they often disturb industry, and the expenses of collection are often large.

9. While *taxing commodities* care should be taken to avoid as far as possible the taxation of necessities, of commodities with an elastic demand, and of commodities, subject to increasing returns. Luxuries, specially harmful luxuries and commodities, the supply of which is monopolised, are specially fit subjects for taxation.

10. The *income tax* has great merits—it is equitable, productive, cannot be shifted easily, and its elasticity makes it admirably fitted for the position of the central tax in a revenue system. The disadvantages relate to its unpopularity, and to difficulties in the administration.

11. The *incidence* of a tax is to be distinguished from its *impact*. The chief factor controlling the incidence and the shifting of the taxes is mobility or elasticity of supply. The subject of incidence is of great importance in connection with the proper distribution of the burden of taxation.

A tax on economic rent, a fixed tax on a monopoly, a tax on monopoly proportioned to the monopoly revenue—these cannot be shifted.

12. The state may borrow for (1) special emergencies like wars (2) for public works (3) for a temporary necessity to meet deficit in the annual budget.

Certain important considerations have to be borne in mind by the statesman and the financier as regards (a) the issue (b) the conversion and (c) the redemption of the public debt.

Questions.

1. Define Public Finance. Why is its study so important?
2. State and explain the law of increasing public expenditures.
3. (a) Give briefly the general principles regulating public expenditures. (b) Classify public expenditures.
4. Enumerate the important sources of public revenues. What are fees? Taxes?
5. Consider the various principles of attaining justice in taxation (C. U. 1913).
6. Discuss whether it is equitable that all classes of the population should contribute something to the tax revenue of the country. (C. U. Hon., 1933).

Refer to SOME EXTRACTS FROM THE COLWEN REPORT (1) Taxation and the Citizen, pages 479-480 of this book.

7. Give the important canons of taxation.

Or,

Upon what principles should a Government determine its tax system? (C. U. 1915).

State and illustrate Adam Smith's canons of taxation. (C. U. 1928).

Define a tax. Explain and illustrate Adam Smith's first canon of taxation. (C. U. 1931).

"The subjects of every state ought to contribute towards the support of its government in proportion to their respective *abilities*, that is in proportion to the *revenues* which they respectively enjoy under the protection of the state." Critically examine the first canon of Adam Smith, and discuss how far the individual's income is a correct measure of his ability to pay taxes. (C. U. Hon., 1932).

8. Give the general arguments for and against progressive taxation. (C. U. 1914, 1909 H.).

How far is progression in taxation possible and how would you justify it? (C. U. 1913).

9. A finance minister has to raise a certain revenue by taxing commodities. What are the general principles which should guide him in selecting commodities for this purpose? (C. U. 1911).

10. Is there any essential distinction between direct and indirect taxes? Discuss the arguments for and against each system of taxation. (C. U. 1910).

Distinguish the comparative advantages and disadvantages of direct and indirect taxation as a means of raising revenue. (C. U. 1910 H.).

11. (a) What are the useful qualities in customs taxes? Discuss the merits and defects of excise taxes.

(b) Give briefly the advantages and disadvantages of an income tax. (C. U. 1918).

12. (a) Explain the terms incidence and impact.

Explain the incidence of a tax on (i) economic rent (ii) interest (iii) profits (iv) wages (v) monopolies.

(b) Consider fully the direct and indirect economic effects of a duty on motor cars in India. (C. U. 1915).

13. For what purposes should the state be allowed to borrow? Sketch briefly the present theory on the subject.

14. Enumerate the different forms of public debts.

15. How would you measure the burden of public debts? Discuss the reason, if any, for the view that an external debt is more burden some to a community than an internal debt. (C. U. Hons. 1932).

Refer to Burden of external debt and of internal debt, pages 480-481 of this book.

What are the considerations which should have weight with a finance minister in determining (a) the issue (b) the conversion (c) the repayment of public debt. (C. U. 1912).

Some extracts from

The Colwyn Committee Report.

(1) Taxation and the Citizen.

*"We consider it important on broad grounds of citizenship that taxation should not be confined to a comparatively small section of the population. It would be a bad state of affairs if a large majority of citizens were themselves to make no actual tax contribution, and were to enjoy benefits provided entirely by the taxation of the few. Under conditions approaching the ideal—which would imply, *inter alia*, a satisfactory standard of living for the lowest-paid workers—all would make some contribution, and would make it knowingly."*

The actual position is that all classes make some contribution, and this in itself we regard as satisfactory; but the great majority contribute only in the form of indirect taxes, and these, being wrapped up in price, are so unobtrusive that they are probably not much realised, except when attention is specially drawn to them. It would be better, from the point of view we are considering, if the great body of citizens were more conscious of the taxes which they bear. The question is partly, though not wholly, one of "taxation and representation." It appears to us that it would be damaging to the sense of responsibility in an electorate that a large section should be able to vote for some perhaps expensive policy, feeling all the while that, because they were not personally liable to taxation, the expenditure would not touch them in any way."*

(2) Taxation and Expenditure: The Expenditure Side.

Burden of external debt and of internal debt.

... It would be impossible to form any just estimate of the effects of existing taxes, without giving some attention to other objects of Government expenditure; for as Mr. J. A. Hobson expressed it, "the general long-range effects of taxation upon trade largely hinge upon the uses made by the state of the tax revenue." (*E. in C. 20*).

We may slightly vary the classification of expenditure made by Mr. W. T. Layton in his evidence before us, and take the following headings:—

- (i) *Service of the External Debt.*
- (ii) *Interest on the Internal Debt.*
- (iii) *Repayment of Internal Debt.*
- (iv) *Pensions.*
- (v) *Defence.*
- (vi) *Social Expenditure.*
- (vii) *Other Services.*

The first three of these headings are our primary concern.

(i) Service of the External Debt.

In discussing the nature of the external debt (*cf. para. 71 et seq.*) we have seen that it involves a very heavy burden, although we do not forget that the resources lent to the country were of the greatest value for the prosecution of the War. Payment of interest on the present external debt, and repayment of the capital sum, while clearly essential to our credit, have to be made without any tangible return. They do not add to the wealth of the country, nor do they create within the country any new source of saving or purchasing power. . . . the much larger, but in other ways less burdensome, internal debt."

* From the point of view of ease of collection the unobtrusive character of indirect taxation is, of course, an important virtue.

(ii) Interest on the Internal Debt.

The large proportion of the tax revenue corresponding to interest on the internal debt is redistributed within this country. It adds to the potential saving and purchasing power of the interest receivers what is subtracted from the tax-payers. No one can say exactly what is the effect of the transfer, either on the national savings or on the distribution of wealth. It would be necessary to know the answer to the question—who are the tax-payers? Who are the interest receivers? What use would the tax-payers have made of the money? What use, in fact, do the interest receivers make of it?

(vi) Social Expenditure.

Of the state expenditure discussed under the five preceding heads, the immediate advantage of the first three taken together (debt expenditure) may be said to accrue on balance to the wealthier section of the community. The immediate advantage of the fourth (pensions) accrues on balance to the poorer section, while that of the fifth (defence) is so general that no distinction can be made in either direction. The immediate advantage under the present section is deliberately conferred upon the poorer.

Social expenditure brings the claims of production and distribution into sharp contrast, and to a certain extent into conflict. The greatest social advantage and the best interest of production are, however, not so hostile to each other as might appear. For, as Professor Pigou has said, "from a distributional point of view, it would plainly be best to take nearly all your money from the rich people, but that might be so bad from a productive point of view that the poor people would in the end be damaged." (Q. 574).

It is clear enough that the distribution of wealth in this country is very uneven, and that social expenditure is not only highly necessary as a matter of humanity and social justice, but is also, up to a point, essential to the promotion of industrial efficiency. It makes for physical and mental well-being, for happiness and for energy. Moreover, it supports and steadies the purchasing power over consumption goods, which is unreservedly beneficial to industry, provided there is a demand for productive goods in due proportion.

On the other side must be set the hard fact that there is a limit to what the country can afford.

(3) The use of the term "Incidence" as distinct from "Effects".

In general usage the term covers not only the initial burden of a tax, but also the whole range of consequential effects. Economists, however, have given it a narrower meaning. For them "incidence" is only concerned with the question on whom the more immediate burden

of the tax as a tax rests. This is the first^{*} thing to be decided about any tax. It is to be distinguished from the question of further effects, which may be exceedingly important.

For the purpose of analysis we think it useful to follow the economists in using the term incidence of taxation in this narrow sense, distinguishing it sharply from the further effects of taxation, and dealing separately with the latter.

The Incidence of the Income Tax.

Opposed Theories: the Economic Argument.

The question of incidence is of special practical moment in the case of the Income Tax. There are two current views; according to one a general Income Tax cannot be shifted by the person on whom it is laid, while according to the other it can be shifted, and is in fact shifted, in the form of an addition to price.

If and so far as the latter view is correct, the Income Tax must abandon part of its chief claim to virtue as a method of taxation. However carefully graduated, it can no longer be said to satisfy the canon of ability to pay, if the burden is indiscriminately shifted: if this happens, no one can tell how much tax he really suffers. . . .

Several of the business men who came before us were of the opinion that Income Tax enters into prices.

(4) Equity of Progressive Taxation up to a certain limit.

"Progressive taxation, under which income, as it increases, bears tax at a higher rate per pound, is the fairest as between individual tax-payers, since it allows for the increased capacity of each additional pound of income to bear taxation (cf. para. 330 et seq.). The principle of progression may, however, be carried to such a point as to lead, in turn, to unfairness against the wealthier tax-payer. Regressive taxation, under which income, as it increases, suffers at a lower rate per pound, is deficient in point of equity. It might be inferred that a good tax-system would give no place to indirect taxes, which cannot be fitted to the individual's ability to pay, and which are unavoidably regressive, if levied upon articles of general consumption. Such a conclusion would miss the mark for several reasons."

(5) The Advantages of Indirect Taxation.

(i) *"Indirect taxation is the most effective way of levying a contribution to national expenditure from the mass of wage-earners. A universal Income Tax would be very unpopular and difficult to administer. On the other hand, to raise the whole revenue from direct taxes on two or three million citizens would be unduly to narrow the basis of taxation. There is great force in the argument which connects taxation with representation."*

(ii) Progressive taxation, such as the present Income Tax and death duties, cannot be carried beyond a certain point without jeopardy to saving and enterprise. Harm may be done to trade, and, if so, there will be reactions on employment and on the standard of living of the poor. Thus the system may break down.

(iii) While indirect taxes, such as the Customs and Excise duties, are regressive, they may have special virtues. This is true of the tobacco and alcohol duties, which raise a large revenue out of the expenditure of individuals in all ranks of wealth, without undue reactions on personal efficiency."

(6) The Income Tax.

We conclude with regard to *the supply of capital* from individual and corporate savings, that industry has suffered materially from the effect of high Income Tax and Super-tax.

We conclude with regard to *enterprise*, that the effects of high income taxation have been almost negligible in the field of employments and professions; over a great part of the industrial field, while appreciable, they had not been of serious moment, but it is clear that they must often have put a check on the more speculative class of business. This holds good particularly of private business, in a sphere where the individual with large resources has usually been considered best able to initiate pioneer work. Wider causes than taxation, however, and particularly the dislocation of our old export markets, must be held mainly responsible for the lack of buoyance in recent years. Relatively, income taxation has not been a factor of high importance."

(7) The Death Duties.

"We may very briefly sum up our main conclusions in regard to the effects of the death duties. In the lower ranges of capital value the Estate Duty is comparatively light, and it is only in estates upwards of £50,000 that the burden becomes markedly severe. In the largest estates, although not so crushing as is sometimes represented, it is very heavy, and leads, we believe, to considerable avoidance.

Owing to the fact that the Estate Duty is levied on estates in transit, its weight is, on the whole, less acutely realised than correspondingly heavy taxation of income. For the same reason, several incidental inequities are less damaging to the duty than they would otherwise be. Although *the duty, when regarded separately, is less equitable than the Income Tax*, it forms a valuable supplement to it, capital and income together furnishing a better criterion of ability to pay than either could in isolation.

Special inconvenience and hardships are sometimes caused to agricultural landowners and also to private businesses, and in a minority of cases the damage done may be considerable. At the same

time, with regard to businesses, it is probable that the duty, amount for amount, is *rather less of a deterrent to enterprise than the Income Tax*. As regards the effect on savings, we think that the Estate Duty, taking physical and psychological effects together, is distinctly more prejudicial, amount for amount, than the Income Tax; this is due partly to the nature of Estate Duty as a deferred tax, and partly to the fact that the bulk of the duty is drawn from the largest estates. . . .

The Legacy and Succession Duties are minor imposts. While their form is open to some criticism, they appear to us to be based on a sound principle, in that they go some way to differentiate the total death duties burden according to consanguinity."

(8) The Capital Levy.

"Immediately after the War the argument for a levy was much stronger than it is now. Apart from the prospect of price deflation (which may have been imperfectly realised) and of heavy annual taxation (which may have been over-estimated), there were other advantages. In particular, the end of the War was a unique occasion which the more wealthy classes of the nation might well have been asked to mark by a special and personal contribution. In present circumstances the advocates of a levy have a far weaker case. Certainly, whether regarded as a means of lightening the annual burden on industry or as a means of reducing indirect taxes and increasing expenditure on social objects, it would, in our opinion, yield physical results quite disproportionate to the magnitude of the operation

Effects of a levy, if badly received.—If the levy were regarded from the first with intense fear and hostility, it would immediately set in motion a whole train of ill consequences. There would no doubt be active propaganda which would accentuate opposition, and it would be exceedingly difficult for the Government to explain the real nature and intention of their proposal so as to make it at all acceptable. We anticipate that the value of securities would quickly depreciate, that traders would reduce their stocks and their demand for credit, and that rapid deflation would ensue, which it would be exceedingly difficult to correct. This would involve serious friction and dislocation over industry as a whole, with very damaging effects on employment. The task of administering the levy would be rendered extremely difficult and perhaps impossible.

The disturbance created by the levy would far outweigh the good effects of reducing the debt. The general effects might be so detrimental to trade that the ordinary revenue would sharply decline and make any immediate relief from taxation out of the question. Finally the long-range effects would be injurious. Saving and enterprise would alike suffer, and the return to trade prosperity would be endangered, and in any event seriously postponed.

The credit of the country abroad would suffer a severe shock, and, indeed, it is difficult to define any limit to the widespread harm that might be done to our trade and commerce.

We conclude that, even if there were a prospect of a Capital Levy being well received, the relief from debt which it offers would be insufficient to justify the experiment so large, difficult and full of hazard; this would hold good in any circumstances not differing widely from those of the present time. Further unless a levy were accepted with more goodwill than it would be possible to anticipate under present conditions, it would be highly injurious to the social and industrial life of the community."

CHAPTER II.

Economic Functions of Government, Socialism etc.

The State.

The functions of the state with reference to economic activities have been thus classified—the state may (I) *own and manage industries* itself (II) *regulate* economic activities and check undesirable features (III) or positively and actively *encourage* economic activities which are deserving of such encouragement.

(I) State-owned and State-managed industries.

The state may undertake to own and manage industries of certain kinds (a) *to develop the national industrial life* or (b) *to achieve social, political or economic ends* which would not be realised otherwise.

(i) Social monopolies.

There are certain kinds of business (for example the supply of gas, water or tramways etc., in towns) which are bound to be organized as monopolies and so these have been called social monopolies. *The governmental management of these social monopolies has been advocated, on the ground that it will*

prevent the abuse of monopoly power by private business men and will benefit society. There are however practical difficulties specially in huge towns like Paris or New York or London where these industries would be on an enormous scale but at least there should be government regulation even in these cases.

(ii) *Where the purity of the supply is a matter of supreme importance as in the case of the currency*, the state may think it advisable to provide the supply itself and not to depend upon private enterprise.

(iii) There are certain *economic services which would never yield a profit to private enterprises* but which must be undertaken by the state on account of the *large consumer's surplus* which the community would get from the provision of these services.

(iv) There are certain cases in which there would be profits in the long run even for private enterprises, but the stimulus of private gain at some distant future is not sufficient to induce private enterprisers to bring about the required supply in the present. *Railways (or irrigation works) constructed to hasten the economic development of the country*, these would be paying in the long run even for private enterprisers, but as they are not willing to wait for so long they have often to be constructed by the state.

(v) The state is the guardian of the interests of unborn generations and so has to take measures for *afforestation, conservation of natural resources*, etc. Private enterprisers looking to immediate gains are not fitted for looking after these things.

(vi) *The development of national industrial life.* The state has sometimes to pioneer industries by state help and under state management; and it often manages railways and transport industries not for the sake of mere commercial profit but with a large outlook so as to bring about the development of national industrial life.

(vii) Then there are industries which are owned and managed by the state for *political reasons* e.g., national defence. Industries engaged in the manufacture of munitions will furnish examples.

(II) State regulation of economic activities.

State control is required when private business enterprise has strength but is likely to injure society in some ways. Here control is wanted to regulate private enterprise and to prevent the injury. State control of private enterprise is wanted in social monopolies when state management is not practicable and it is also wanted to prevent adulteration and other injuries to society.

(III) State encouragement of industries.

Such encouragement is required when private enterprise is not sufficiently strong and more strength and enterprise are wanted in the interest of the community. The encouragement given by the state takes various forms :

(a) The state may encourage directly by *bounties or subsidies*. The bounty may take the form of *guaranteed minimum of profit* and it may take other forms.

There may be bounties on production or for export.

(b) The state may encourage native industries indirectly by protecting them from foreign competition.

Refer to Part II pages 257-262.

Railways and the State.

In many modern countries, railways are owned and managed by the State. In the United States and in England railways are privately owned and privately managed but under state regulation and control ; and a fundamental problem of railway organization in these countries is whether the present system should be continued, or whether it should be replaced by government ownership and government management of railways.

(a) *Arguments in favour of private ownership and management (and against government ownership and management)*. Some principal arguments advanced by the advocates of private management are (i) the greater efficiency of private management (ii) the greater elasticity of private management in meeting the varying demands of business (iii) the danger of undue favours

to employees under state management specially in democratic countries where railway workers have votes and political influence (iv) the danger that railway rates, and railway expansion etc., would be influenced too much by politics and too little by sound financial and economic considerations.

(b) *Arguments in favour of public (i.e., government) ownership and public management and against private ownership and private operation.*

Some arguments advanced by the supporters of public ownership and management are the following:

(1) The state would look to the interest of the people as a whole, their industrial development; private management looks only to profit.

(2) Elimination of personal discrimination and all other kinds of unfair tactics as regards railway rates etc.

(3) At present railways under private management in the United States and elsewhere exercise a corrupt influence on politics; their tortuous management and ominous consequence in the greater inequality of wealth are other serious evils. These will disappear under state management.

The State and Trade.

The question as to the proper relation of the state to trade, what are the advantages of abolishing government restrictions on trade, and under what conditions, and also the cases in which restrictions on trade become necessary and desirable—these are discussed in the chapter on International Trade.

The State and Labour.

For the relation of the state to labour, and the necessity of imposing restrictions on labour in the interest of the labourers themselves, and also in the economic, political and social interests of the community as a whole—see Labour Legislation, and Factory Laws, Book v. ch. iv.

The State and the Poor.

See *Poverty and Poor Law*, Book v. ch. iv.

PRESIDENT ROOSEVELT OF THE UNITED STATES ON THE ECONOMIC FUNCTIONS OF A MODERN GOVERNMENT.

The World Economic Depression has brought about a notable experiment in the United States as regards the economic functions of a Modern Government. In peace time the U. S. A. Government under President Franklin D. Roosevelt (the National Recovery Administration) has assumed and is exercising vast, unprecedented powers in the extensive control over prices, production of goods, wages, conditions of employment, currency and credit all over the country. Roosevelt's basic ideas are stated by him in the following words :

"Recently a careful study was made of the concentration of business in the United States. It showed that our economic life was dominated by some six hundred-odd corporations, who controlled two-thirds of American industry. Ten million small business men divided the other third.

More striking still, it appeared that, if the process of concentration goes on at the same rate, at the end of another century we shall have all American industry controlled by a dozen corporations and run by perhaps a hundred men. Put plainly, we are steering a steady course toward economic oligarchy, if we are not there already.

Clearly all this calls for a reappraisal of values. A mere builder of more industrial plants, a creator of more railway systems, an organiser of more corporations, is as likely to be a danger as a help. The day of the great promoter or the financial titan, to whom we granted everything if only he would build or develop, is over.

Nor to-day should we abandon the principle of strong economic units, called corporations, merely because their power is susceptible to easy abuse.

As I see it, the task of government in its relation to business is to assist the development of an economic declaration of rights, an economic constitutional order. This is the common task of statesmen and businessmen. It is the minimum requirement of a more permanently safe order of society. Happily, the times indicate that to create such an order is not only the proper policy of government, but is the only life of safety for our economic structure as well.

We know now that these economic units cannot exist unless prosperity is uniform—that is, unless purchasing power is well distributed throughout every group in the nation. That is why even the most selfish of corporations, for its own interest, would be glad to see wages restored and unemployment aided, and to bring the farmer back to his accustomed level of prosperity, and to assure a permanent safety for both groups. This is why some enlightened industries endeavour to limit the freedom of action of each man and business group within the industry in the common interest of all. That is why business men

everywhere are asking for a form of organisation which will bring the scheme of things into balance, even though it may in some measure qualify the freedom of action of individual units within the business.

... Every man has a right to life and this means that he has also a right to make a comfortable living . . . Every man has a right to his own property, which means a right to be assured to the fullest extent attainable, in the safety of his earnings. By no other means can men carry the burdens of those parts of life which in the nature of things afford no change of labour—childhood, sickness, old age. In all thought of property, this right is paramount; all other property rights must yield to it. If, in accordance with this principle, we must restrict the operations of the speculator, the manipulator, even the financier, I believe we must accept the restriction as needful, not to hamper individualism, but to protect it.”—F. D. Roosevelt, *Looking Forward*, 1933, pages 31-35.

SOCIALISM. ECONOMIC PROGRESS.

The present distribution of wealth.

I. Arguments against the present distribution of wealth.
(see Part II pages 298-302).

II. Arguments advanced in justification of the present system of distribution of wealth.

(A) Economists of the Classical School.

The economists of the classical school, and of the optimist school regard *the present distribution of wealth as perfectly just*. They argue thus: under the present system, society is based on the liberty of labour and the absolute freedom of contract and *every one receives the just and exact equivalent of the wealth he creates by the law of supply and demand*. Society by the law of supply and demand determines (i) the prices of agricultural products, manufactured products, etc. (ii) also the shares in distribution (viz., wages, interest, rent and profits) which are the prices of the service of labour, capital, land and organization. The public is the best judge, and the public judges and pays by the law of supply and demand.

These writers also point out that *competition tends to correct any inequalities and injustice that may arise*. If a particular product or service is sold for a time at an excessively high price, numerous rivals immediately throw themselves into the same industry or career, and thus bring down the value of the product or the service to the level of the cost of production.

[Other arguments advanced in favour of the present system of distribution are (i) *it stimulates productive activity* by allowing each individual to act freely in his own interest, and to keep to himself the fruits of his labour.

(2) Moreover the present system possesses an advantage over all other imaginable distributive systems in this—the *present system works automatically* by the law of supply and demand and it does not require any distributive authority which

is wanted under other systems. (3) Again the *present system secures liberty* which other systems would sacrifice in endeavouring to secure a large measure of justice in distribution.]

(B) Prof. Smart's view.

Prof. Smart, a British economist, takes a more moderate position as regards the justice of the present system of distribution, and in this he represents a part of recent economic thought on the subject.

Smart admits that perfect justice has not been attained ; but he points out that something curiously like a *rough justice* has emerged. "At least it is not a

A kind of rough justice in the present distribution, as it measures payment roughly by service.

distribution to idlers ; nor a distribution by force or fraud nor a distribution due to the favour of the distributors, to patronage, or to privilege. *It is, in some sense, a distribution according to product, and is based on mutual service.*" The rough justice of present distribution is established by pointing out how far arbitrary division is eliminated. At least payments are not arbitrary where there is mobility. (a) The payment of labourers is prevented from being arbitrary by the mobility, and the solidarity of labour. (b) As regards employers, competition between them prevents the arbitrariness of profits. (c) As regards capital, capital also is prevented from getting an arbitrary remuneration by its mobility. When the supply of capital increases rapidly, the rate of interest falls, and there is difficulty in getting employment for capital.

Prof. Smart rightly makes a modification in this claim of rough justice—it is *such justice as we can have under a system of private property and free transfer of property*. [In considering the arguments against private property, he asserts that (i) rent under modern conditions (with continual sale and resale of land as an investment, and the development of communications) is not a strong argument against private property, (ii) and interest is also not a strong argument because the man using borrowed capital and paying the present rates of interest gets a great deal of work out of the capital.]

And his conclusion is this: "*At least there is enough of rough justice in it to make even those of us who feel its imperfections most keenly think twice before we give our countenance to any rival scheme which has yet been proposed.*"

Of such rival schemes, socialism with its many varieties is at present the most influential and important. .

* Socialism.

The existing system of distribution of wealth and also its production are closely dependent upon the legal structure of society specially upon the laws of private property and competition. Socialists regard the present system of distribution of wealth as extremely unjust. And the search for a better system of distribution has given rise to numerous systems of Socialism. Thorough-going modern Socialists propose not only vast and far-reaching changes in distribution but also corresponding changes in production and exchange and these changes necessitate fundamental changes as regards the laws of property.

Socialism is not always violent and lawless—there are socialists, violent and lawless, who are for anarchy and dynamite, but there are many socialists who are opposed to all violence and advocate peaceful methods and progressive evolution. Again *socialism is not essentially anti-Christian or anti-religion*—though Marxian and other continental socialists generally reject Christianity, there have been many socialists among the leaders of the Christian Church in recent times, Maurice, Kingsley, Dr. Clifford in England and others elsewhere. Nor do all socialists aim at abolishing the family or encouraging free love.

There are many kinds of socialists and there are many kinds of socialism. Moreover Socialism is still in the process of development and change—it is not a stereotyped system

* What is socialism? It is almost like asking "What is Christianity?" Or demanding to be shown the atmosphere. It is not to be answered fully by a formula or an epigram Socialism then is a great intellectual process, a development of desire and ideas that takes the form of a project . . . a project for the re-shaping of human society upon new and better lines. That in the ampler proposition is what socialism claims to be."—*New Worlds for Old*—H. G. Wells.

of dogma, it is living, it changes and develops and it will change and develop with the intellectual and moral development of modern societies.

The word Socialism appears to have been first used in *The Poor Man's Guardian* in 1833. Among modern socialists the important names are (1) in France—Saint Simon, the historic founder of French socialism, Fourier, Louis Blanc and Proudhon; (2) in Germany—Ferdinand Lassalle, Rodbertus and Karl Marx, undoubtedly the greatest figure in modern socialism; (3) in England—Robert Owen, Maurice, Kingsley, and in recent times William Morris, Sidney Webb and others.

History of Socialism.

(1) The utopian socialism in the early nineteenth century.

Earlier French and English socialism down to 1848 was largely *utopian and idealistic*. (It was also dominated by a *bourgeois or middle-class spirit and was not of and for the working class*).

These early socialists impressed with the evils of the competitive system and private business enterprise proposed socialistic schemes which were expected to remove these evils. These socialists are called *utopians* and their socialism *utopian socialism* because *they reasoned from ideal postulates and they advocated the regeneration of mankind through education and brotherly love in ideal communities*. Unlike many modern socialists they did not want a revolution to establish a socialist state but they appealed to the dominant classes for aid to carry out their social programme.

The most important of the earliest socialists were Robert Owen, Saint Simon, Fourier, Cabet and Blanc. (Short accounts of their socialistic schemes are given at the end of the chapter). Blanc was however less utopian than the others.

(2) The proletarian and 'scientific' socialism of the latter half of the 19th century.

We now pass to the *proletarian socialism*, of the second half of the nineteenth century, a socialism of and for the working class. And this socialism calls itself a *scientific socialism*, it prides itself upon its *scientific realism* and ridicules the utopian ideals of the earlier socialists.

The 'scientific' socialists fall into two important groups :

(a) State socialism.

The advocates of state socialism are nationalists and propose that the socialistic programme is to be accepted by the state and to be carried out by the national government.

The leaders of this school are Rodbertus and Lassalle. The influence exercised by Rodbertus on economic thought has been very considerable.

Rodbertus's economic thought proceeds from two main ideas.

(1) A labour theory of productivity—labour produces all economic goods. (2) A belief in a decreasing wages share. The second idea is connected with his theory of the iron law of wages.

Rodbertus is not for revolutionary methods. His position is 'social, monarchic' and national.'

(b) International socialism of Karl Marx.

Like Ferdinand Lassalle, Karl Marx was a Jew, and a German Jew by origin. The Jews have produced many great names in philosophy, letters, art, music and science, but few greater than that of Marx. With Marx socialism took on a purely materialistic garb and became international in scope as contrasted with the national industrialism or state socialism of Rodbertus.

The international socialism of Marx is revolutionary in temper and it is abstract and deductive. Some principal features of scientific socialism as taught by Marx are the following:

(1) Society is an evolutionary product.

(2) *History is to be given an economic interpretation*, i.e., the history of our whole social life including religion, government, art, etc. is the result of past and present economic conditions.

(3) **Marx's theory of value and his doctrine of surplus value.*

Marx thinks that labour produces all value, capital being nothing but stolen labour. The whole value of a commodity depends upon the quantity of labour expended upon it. In its quantitative aspect, value is reduced to socially necessary labour-time—to the time spent by the average labourer in producing the commodity under existing social conditions.

* Marx distinguishes between use-value and exchange-value.

"The utility of a thing makes it a value."

As regards exchange-value Marx remarks "We see then that that which determines the magnitude of the value of an article is the amount of labour socially necessary or the labour time socially necessary for its production. . . . The value of one commodity is to the value of any other as the labour-time necessary for the production of the one is to that necessary for the production of the other. As values, all commodities are only definite masses of congealed labour-time."

The *doctrine of surplus value* is that the labourer produces more than he gets as wages, and the surplus value which is produced by him is appropriated by the capitalist, the employer and the landlord in the shape of interest, profit and rent. The labourer is thus deprived unjustly of a large part of the value produced by his labour.

(4) *The doctrine of the class struggle.*

The exploitation of the labouring class by the capitalist and the landlord classes produces a profound antagonism between these classes; and this antagonism has given rise to a class struggle which can end only in the overthrow of the capitalist and landlord classes and the triumph of the labouring class and the establishment of the socialist state.

Marx is unquestionably the most powerful personality in the history of socialism and his *Capital* (*Das Kapital*) has been called 'the Bible of socialism'. This work of Marx is a study and a criticism of capital, but indirectly it is a brilliant exposition of socialism armed with all the learning of the nineteenth century.

Some criticisms of Marx's theory.

Marx, brilliant and suggestive as he is, is open to serious criticism on many points.

(1) History should not be given a purely economic interpretation. The history of mankind is influenced by economic, religious, political and other causes.

(2) The Marxian theory of value is also unsound and his theory of value is the heart of his whole system. The Marxian theory of value is unsound (a) because it neglects the factor of utility and does not deal with utility at all adequately, (b) because even assuming that cost alone can explain exchange value, it is not true that all cost can be reduced to labour. (Value is due not to labour cost alone). (c) The Marxian theory of value also breaks down before differences in the quality of labour. The doctrine of surplus value is thus not founded on facts.

(3) The doctrine of class struggle also is not completely borne out by facts. The struggle between the classes is not growing more and more acute everywhere; and many socialists to-day are of opinion that the victory for socialism would be won without blood-shed (and through the labourers securing a majority in the national parliament and establishing socialism by parliamentary legislation) and not by bloody revolution as Marx expected.

The revolutionary and the evolutionary Socialists.

Marx, Engels and their orthodox followers were revolutionary socialists, who expected that the socialist state would be established by a revolution. A very large body of socialists at the present day have

a socialism which is not revolutionary but evolutionary. And these evolutionary socialists believe that the socialist state would be established without blood-shed and revolution and as a result of a gradual increase in the strength of the socialist party as a political organization in most modern states. The majority of socialist leaders of the present day in many modern countries are evolutionary socialists.

The tendency among modern socialists is to reject certain parts of Marx's theory and to maintain the rest, to reject the materialistic interpretation of history and the theory of surplus value, while accepting the doctrine of the class struggle, internationalism and the socialisation of the instruments of production. Some leading figures among recent socialists are Bernstein in Germany, Jaures in France, Sidney Webb in England. The evolutionary socialists are also called *revisionists* or *opportunists*.

Lenin and Trotsky, the leaders of Bolshevik Russia, profess to base their socialism on the pure, undiluted doctrine of Marx—but the amount of genuine socialism in the Russian proletarian dictatorship has been questioned by competent socialist observers, Bertrand Russell and others.

* Character of Modern Socialism.

Modern state socialists would expand the business functions of the state, so that all industries would become state industry managed by the state. *Private economic activity is to be ended and to be replaced by public economic activity.* And all such business would be regulated by the people in their organized capacity. The present political organization is to become an industrial organization based upon the will of the people and their suffrage. In this way, *there will be industrial democracy as well as political democracy.*

The socialists propose

- (1) State ownership of the instruments of production, viz. Land and Capital.
- (2) State management of the instruments of production, and production of wealth under state control and management.
- (3) The distribution of the product of industry (*i.e.* the

* Not all socialists are for basing Socialism upon the state as we know it. The early utopian socialists depended upon private effort and experiment, and on the other hand, Marx was for a vast international combination of the labourers of all nations without distinction of creed, colour and nationality—but modern state socialists would make the state itself socialistic, and would base socialism upon the state as it is.

national income) among the different classes by the authority of the state.

They do most seriously object to the ownership of capital or of land by private persons because private ownership of the means of production leads to the exploitation of the labouring classes.

Though the socialists object to the private ownership of instruments of production, all of them are not opposed to the existence of private property in income earned by individuals under the socialist state.

Socialistic criticism of the Modern State.

Socialists of different schools criticise the existing system of production and distribution of wealth as carried on under the Modern State. They put forward economic as well as moral and social objections against the present industrial system.

I. Economic objections against the present system (and economic advantages claimed for socialism).

(1) *Production under the present system is inefficient because of the wastes of competition and the haphazard methods of present industry.*

Socialists declare that in their system production will be scientifically organized and would be much more efficient. They claim that (a) the economic needs of the community will be accurately estimated, and the available land, labour and capital carefully apportioned so that just the quantity of each kind of goods required will be produced.

(b) The duplication of plants and staffs and the excessive production of particular goods, now so common under competition, will be avoided.

To quote Prof. Ely† "Competition is wasteful. Two railways are built where one would suffice.....look at the shops, wholesale and retail, and see the waste of human force. Without competition the whole dry goods and grocery business could be carried on with a third of the present economic expenditure of force."

† Ely—*Outlines of Economics*, 1910, page 520.

(c) Socialism would save the enormous *expenses of advertising and competitive selling* incidental to the present system.

(d) In the modern state there are the *idle classes* who spend but do not work. Socialism would make them work for their bread.

(e) *Unemployment* which becomes widespread with the coming of crises and depression is one of the serious evils of the modern industrial organization. Socialists claim that they will abolish unemployment by a more scientific organization of production.

(2) The present *distribution of wealth* concentrates wealth in the hands of a few rich landlords, capitalists and business men while the vast majority of workers get less than their proper share of wealth and are poor. Socialists declare that they would establish a just distribution.

(3) *Then as regards consumption.*

To-day goods are made by producers for sale ; they would be made for use, for the benefit of the consumer in the socialist state. Socialism would suspend the production of harmful goods and would abolish adulteration and deception.

II. Moral objections against the present system (and moral advantages claimed for socialism).

The injustice of the present system of distribution is a grave moral objection. *The fundamental objection is that modern industry is based upon self-interest. Socialism is based on worthier motives.* Under it all men would live like brothers. "Socialism relies upon the love of activity for its own sake, the desire to contribute to the common good.....and the ambition to win social esteem and social distinction through conspicuous social service."

*** Some elements of truth in Socialism and in the Socialist criticism of the Modern State.**

The socialistic criticism of the modern state and the constructive programme of the Socialists make clear the

* For a vigorous and popular exposition of the case for modern socialism, the student is referred to *New Worlds for Old*—H. G. Wells.

elements of truth in socialism. The strength of socialism lies chiefly in the (1) claim for a scientific organization of the national production of wealth, and the socialistic criticism of present waste and also of the idle rich who do not work ; (2) for a just distribution of the national income. Other elements of strength are socialistic criticisms (3) of the present capitalist and competitive system in the matter of unemployment (4) of adulteration, deception and cheap and nasty goods which are the outcome of the system of private capitalism in which goods are made to sell and not for use and (5) finally of the selfish spirit of competition.

Defects of Socialism as regards (A) its criticism of the Modern State (B) its own constructive programme. (*The arguments against Socialism*).

The weakness of Socialism lies (A) partly in the weakness of some of the arguments employed by the Socialists against the modern state ; (B) partly in the defects attaching to the constructive programme of the Socialists themselves for the establishment of the Socialist State.

(A) The following among other things are elements of weakness in Socialism :

(1) The predictions of Marx and his followers about the modern state have been to some extent falsified so far, and the evils of the present system may be removed in future without the establishment of socialism.

(2) The Marxian doctrine of the class struggle, and the economic interpretation of history as given by the socialists are partly at least erroneous.

(3) The socialists underrate the productive efficiency of the present capitalist and competitive system. Under the present system the production of wealth has greatly increased in every modern country.

The socialist sees the suffering and starvation, waste in production and extravagance in consumption in connexion with the present system ; but he ignores the thousands of happy homes scattered throughout the land in rich and progressive countries like Britain, France and the United States.

(B) *Defects in the constructive programme of Socialism about the establishment of the Socialist State.*

(1) In the Socialist State, the *difficulties of administration* would be serious and substantial. There would be difficulties relating to the apportionment of labour among the various industries, specially as regards unpopular occupations, about the assignment of value to products, about the quantity of goods to be produced, the relative proportion of capital goods and consumers' goods etc.

(2) It is feared by many leading economists that *industrial progress would be hampered* under the socialist state, and production will be less efficient than under the present regime.

In the absence of the incentive of competition and the stimulus of private ownership and private enterprise, the *accumulation of capital, and also inventions and improvements may be checked.*

(3) *A great difficulty would arise in connection with the distribution of the national income.* On this question socialists differ among themselves. Some advocate equal distribution, others advocate distribution according to needs, others are for distribution according to efficiency.

(4) *Political and social dangers of Socialism.*

Then there is *the danger to liberty* and also other evils of a political and social character under socialism. Everything (the choice of occupation, methods of production etc.) would be completely regulated by the gigantic bureaucratic machine, and possibly there would be an end of individual liberty, initiative and enterprise. The loss to society and civilisation under these circumstances may be incalculable.

And under present conditions of public morality, there would be an immense amount of political corruption, intrigue, personal spite and favouritism on the part of the rulers of the State (however they may be elected or appointed).

(5) Perhaps the socialists make the fundamental mistake of under-rating the *psychological obstacles* to their plan. Perhaps the average man is neither so inclined to work nor so zealous for the common welfare as socialism demands. But it

is just possible that the psychological obstacles may be largely overcome by an appropriate system of education.

Bertrand Russell on the Socialist State.

Many Socialist writers have sketched their Socialist State of the future.

Bertrand Russell paints an attractive picture of the Socialist State :

"Education should be compulsory up to the age of sixteen, or perhaps longer; after that, it should be continued or not at the option of the pupil, but remain free (for those who desire it) up to at least the age of twenty-one I think we may assume that, with the help of science, and by the elimination of the vast amount of un-productive work involved in internal and international competition, the whole community could be kept in comfort by means of four hours' work a day. It is already being urged by experienced employers that their employees can actually produce as much in a six hours' day as they can when they work eight hours

Payment will not be made, as at present, only for work actually required and performed, but for willingness to work.

There would still have to be money, or something analogous to it, in any community such as we are imagining

The expense of children will not fall, as at present, on the parents. They will receive, like adults, their share of necessities and their education will be free

Government and Law will still exist in our community, but both will be reduced to a minimum. There will still be acts which will be forbidden—for example, murder,

When elementary needs have been satisfied, the serious happiness of most men depends upon two things: their work and their human relations. In the world that we have been picturing, work will be free, not excessive, full of the interest that belongs to a collective enterprise in which there is rapid progress, with something of the delight of creation even for the humblest unit. And in human relations the gain will be just as great as in work. The only human relations that have value are those that are rooted in mutual freedom, where there is no domination and no slavery, no tie except affection, no economic or conventional necessity to preserve the external show when the inner life is dead. Marriage should be a free spontaneous meeting of mutual instinct, filled with happiness not unmixed with a feeling akin to awe: it should involve that degree of respect of each for the other that makes even the most trifling interference with liberty an utter impossibility, and a common life enforced by one against the will of the other an unthinkable thing of deep horror

What are we to say, lastly, of the effect of our projected world upon physical evil? Will there be less illness than there is at present? Will the produce of a given amount of labour be greater? Will men in such a world become lazy and apathetic? Will they cease to think? These are important questions; for it is ultimately to science that mankind must look for their success in combating physical evils.

If the other conditions that we have postulated can be realized, it seems almost certain that there must be less illness than there is at present. Population will no longer be congested in slums; children will have far more of fresh air and open country; the hours of work will be only such as are wholesome, not excessive and exhausting as they are at present.

But under a freer system, which would enable all kinds of groups to employ as many men of science as they chose, and would allow the "vagabond's wage" to those who desired to pursue some study so new as to be wholly unrecognised, there is every reason to think that science would flourish as it has never done hitherto. And if that were the case, I do not believe that any other obstacle would exist to the physical possibility of our system.

The system we have advocated is a form of Guild Socialism, And if Socialism ever comes, it is only likely to prove beneficent if non-economic goods are valued and consciously pursued.

The world that we must seek is a world in which the creative spirit is alive, in which life is an adventure full of joy and hope, based rather upon the impulse to construct than upon the desire to retain what we possess or to seize what is possessed by others. It must be a world in which affection has free play, in which love is purged of the instinct for domination, in which cruelty and envy have been dispelled by happiness and the unfettered development of all the instincts that build up life and fill it with mental delights. Such a world is possible; it waits only for men to wish to create it."

• —Bertrand Russell, *Roads to Freedom*, 1928, pages 193-210.

Some leading economists on socialism—Marshall, Seligman, Taussig, Cannan.

Economists differ among themselves as to the difficulties of socialism and its practicability, and they differ in the emphasis which they lay upon the various objections against socialism.

Prof. Marshall, in common with other leading economists, admits that all is not well with the existing distribution of wealth and is in favour of gradual improvements—not for socialism and, sudden and violent reorganisation of the economic, social and political conditions of life. He maintains "that the distribution of the national dividend, though bad, is not nearly so bad as

is commonly supposed;" "that the social and economic forces already at work are changing the distribution of wealth for the better; that they are persistent and increasing in strength; and that their influence is for the greater part cumulative; that the socio-economic organism is more delicate and complex than at first sight it appears; and that large ill-considered changes (like socialism) might result in grave disaster." He points to the economic and social perils of collectivism (socialism) and criticises socialism mainly on the grounds that (1) *socialism is opposed to human nature*, and would require from the whole people 'a power of unselfish devotion to the public good which is now relatively rare', (2) *it would check progress and production of wealth* by discouraging invention and also accumulation of capital. In the existing condition of society, men for their private gain save and accumulate capital (so greatly needed for the development of national industry and trade), and they make inventions relating to machinery and process of production; private gain for the capitalist and the inventor would be abolished under socialism, and so there would be no incentive to invention or accumulation of capital. "There is therefore strong *prima facie* cause for fearing that the collective ownership of the means of production would deaden the energies of mankind, and arrest economic progress, . . . it might probably destroy much that is most beautiful and joyful in the private and domestic relations of life."—*Economics of Industry*, Chapter XV.

Prof. Seligman, one of the chief American writers, holds similar opinions. He also asserts that socialism, if introduced, would stifle economic progress and check production of wealth. "If anarchism forgets the state, socialism forgets the individual. If anarchism exaggerates the possibilities of private action, socialism exaggerates those of public action. . . . In his anxiety to escape from the evils of the present, the socialist is willing to entrust himself to the fortunes of a dubious future. Impatient of the shortcomings of distribution, he does not realise that his scheme will endanger production . . . he does not see that he will stifle progress. In his effort to remove actual inequalities he bids fair to reduce economic life to the hopeless level of a dull and low uniformity. With human nature as it exists at present, and as it bids fair to continue for an incalculable future, socialism, if ever realised in practice, as at present in Russia, would be the death knell of economic advance and true social betterment."—*Principles*, Chapter XXXV.

Another distinguished American writer, Prof. Taussig, thinks somewhat less of the difficulties of socialism. In the socialist state, he asserts, organisation, the valuation of commodities, and the accumulation of capital would not present serious obstacles and that for the mass of men, there would be practically little diminution of real liberty. He seems to be of opinion that the real difficulties will be largely of a psychological character and that the maintenance of vigour, efficiency and progress would be practically impossible both as regards the rank

and file of the workers and also as regards the leaders and also the increase of effective capital through improvement and invention.]

Prof. Cannan, the doyen of the London school, has a sympathetic and progressive attitude towards socialism. In the *Economic Journal* (Sept. 1908) he asks, "Why cannot present-day socialists be a little more courageous? *Nothing in Economics is more certain than that the best distribution—the distribution which makes a given amount of product go furthest—is distribution according to need.* It is equally certain that a community with a perfectly organised system of corporate control could arrange production more economically than it is arranged or likely to be arranged by our present mixed system. What is the difficulty in supposing that, given sufficient time, the corporate organisation may become perfect enough to arrange all production and distribution? . . . *while great things may be expected of corporate management in the future, there does not seem the same reason for expecting improvement in private enterprise.* Profit-seeking works excellently where there is real competition, but as time goes on and the scale of business increases, the easy working of competition is more and more interfered with by aggregation and combination. Consider for example, the English railway system. The management of each railway has been entrusted to a board of a dozen old gentlemen who, though nominally elected by the shareholders, really perpetuate themselves by cooptation. A more absurd method of management could scarcely be devised." And the work would be better managed by a board appointed by politicians who were afraid of the House of Commons and the electors."

A defence of Capitalism—Hartley Withers on "The Case for Capitalism."

Of recent defences of capitalism against socialist attacks, *The Case for Capitalism* by Mr. Hartley Withers is one of the cleverest and has attracted much attention. Socialism is the alternative to Capitalism. Mr. Withers waxes eloquent in his description of the achievements of Capitalism, and enlivens his attacks on Socialism by flashes of his characteristic humour. Two varieties of Socialism are popular now-a-days in England—State Socialism and Guild Socialism (see pages 512-513). Withers states that one main objection against both these varieties of Socialism is that the consumers will have no freedom—they will have to take whatever is produced by the state (under State Socialism) or by the Guilds (under Guild Socialism). But this freedom the consumers do possess in the existing condition of society under Capitalism, they buy what they like and not whatever is offered to them. As against State Socialism Withers declares that it would check national production of wealth and by the establishment of bureaucratic control might have deadening effects on moral and intellectual growth; as again Guild Socialism he asserts that it would check production almost as seriously as State Socialism, that it would produce a selfish and sectional outlook, that there would

the friction and difficulties between the Guilds as to the values at which they would exchange their products, that it might lead to a lowering of the workers' standard of comfort, while it is hard to see that they would gain any real increase of freedom.

And then he continues "In putting the case for *capitalism* in the foregoing chapters, I have by no means meant to argue that it is the best possible economic system, only *that it has worked wonders, and can work still better wonders in the future and that we cannot be sure that any other system that has yet been suggested will do as well.*" Under modern capitalism (introduced in the middle of the 18th century) the world (specially Western Europe and the United States of America, the real strongholds of capitalism) has increased greatly in population and production of wealth and the standard of comfort for the masses of the population has been substantially raised—"Many millions of people were born and lived a life that had a good deal of comfort and jollity, and a certain amount of real nobility mixed up in its queer salad-bowl, who never would have seen the light without the industrial development that was in fact worked out under capitalism". Also Capitalism secures consumer's freedom which would be abolished by Socialism.

He concludes on the following note—"Such is the debt that all of us owe to the capitalists of the past. But when we have taken off our hats to them and acknowledged it, *we have to give our minds to reforming and improving the capitalism of the present.*" The essence of capitalism is competition—competition between rival producers increases efficiency and production of wealth within a country, reduces cost of production, also price to consumers and gives the consumer freedom to buy from any producer he likes. Present capitalism is to be reformed by getting rid of (1) Monopoly, also profiteering which threaten the interests of consumers and (2) the foolish, short-sighted policy of 'continually resisting the claims of the wage-earners for higher wages on the ground that industry could not stand them, when subsequent experience proved that it could.' Unless capitalism is reformed in this fashion, consumers would desire socialism thinking that public monopoly is better than private monopoly, and labourers would desire it believing that they would get what was their due only from the state and not from private employers. Vulgar ostentation in expenditure by the richer classes naturally embitters the rest of the population. This also must go. It is desirable that every capitalist should be a worker, and every worker should be a capitalist. The labourers should save capital and invest it in industry—increasing their income and improving their economic status. The capitalists should work, take part in industry—not live idle lives. "In the meantime improvements in education should give to all a better chance of material success in life, and open the chance of a career to all who have the necessary gifts of courage, honesty, initiative and readiness to take responsibility."

J. M. Keynes and "The End of Laissez Faire."

Marshall and most of the leading economists want a reformed

capitalism. Mr. Keynes wants a reformed capitalism—and the end of *laissez faire*.

The End of Laissez Faire, Mr. Keynes' stimulating little thing, cannot be ignored in any present-day discussion of Capitalism and Socialism.

Mr. Keynes—in this agreeing with some of the best English thinkers to-day—is clearly of opinion that Capitalism is not the last word in Economics. Capitalism is not the highest economic goal. In fact it has in it a great deal of evil. But it can be made much more efficient than it is now, more efficient than any alternative system yet in sight. "For my part, I think that Capitalism, wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight, but that in itself it is in many ways extremely objectionable."

Like the late Prof. Marshall, his *guru*, Mr. Keynes votes for Capitalism. But not for the *laissez faire* capitalism of old days. He is for putting an end to *laissez faire*. He sees in modern tendencies the end of *laissez faire*.

"Let us clear from the ground the metaphysical general principle upon which from time to time, *laissez faire* has been founded. It is not true that individuals possess a prescriptive "natural liberty" in their economic activities. There is no "compact" conferring perpetual rights on those who Have or on those who Acquire. The world is not so governed from above that private and social interest always coincide. It is not so managed here below that in practice they coincide. It is not a correct deduction from the Principles of Economics that enlightened self-interest always operates in the public interest. Nor is it true that self-interest generally is enlightened; more often individuals acting separately to promote their own ends are too ignorant or too weak to attain even these. Experience does not show that individuals, when they make up a social unit, are always less clear-sighted than when they act separately

Perhaps the chief task of Economists at this hour is to distinguish afresh the *Agenda* of Government from the *Non-Agenda*; and the companion task of Politics is to devise forms of government within a democracy which shall be capable of accomplishing the *Agenda*. I will illustrate what I have in mind by two examples.

(1) I believe that in many cases the ideal size for the unit of control and organisation lies somewhere between the individual and the modern state. I suggest, therefore that progress lies in the growth and the recognition of semi-autonomous bodies within the state—bodies whose criterion of action within their own field is solely the public good as they understand it, and from whose deliberations motives of private advantage are excluded, though some place it may still be necessary to leave, until . . . bodies . . . subject in the last resort to the sovereignty of the democracy expressed through Parliament.

. . . . It is easy to give examples, from what already exists, of separate autonomies which have attained or are approaching the mode I designate—the universities, the Bank of England; the Port of London Authority, even perhaps the Railway Companies

But more interesting than these is the trend of *joint-stock institutions*, when they have reached a certain age and size, to approximate to the status of public corporations rather than that of individualistic private enterprise The shareholders must be satisfied by conventionally adequate dividends; but once this is secured, the direct interest of the management often consists in avoiding criticism from the public and from the customers of the concern *They are, as time goes on, socialising themselves.*

. . . . The battle of socialism against unlimited private profit is being won in detail hour by hour We must take full advantage of the natural tendencies of the day, and we must probably prefer semi-autonomous corporations to organs of the Central Government for which Ministers of State are directly responsible.

(2) I come next to a criterion of *Agenda* which is particularly relevant to what it is urgent and desirable to do in the near future. We must aim at separating those services which are *technically social* from those which are *technically individual* The important thing for Government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do things which at present are not done at all I limit myself to naming some instances

Many of the greatest economic evils of our time are the fruits of risk, uncertainty, and ignorance. It is because particular individuals . . . are able to take advantage of uncertainty and ignorance and also because for the same reason that big business is often a lottery, that great inequalities of wealth come about; and those same factors are also the cause of the unemployment of labour I believe that the cure for those things is partly to be sought in the deliberate control of the currency and of credit by a central institution, and partly in the collection and dissemination on a great scale of data relating to the business situation, including the full publicity, by law, if necessary, of all business facts which it is useful to know

My second example relates to savings and investments . . . I do not think that these matters should be left entirely to the chances of private judgment and private profits, as at present.

My third example concerns population. The time has already come when each country needs a considered national policy about what size of population, whether larger or smaller than at present or the same, is most expedient. And having settled this policy, we must take steps to carry it into operation. The time may arrive a little later when the community as a whole must pay attention to the innate quality as well as to the mere numbers of its future members."

Mr. Keynes's plan is thus in part one of directly extending the functions of the state as regards services which he describes as "technically social"; and in part one of gradually socialising capitalism through semi-autonomous bodies subject to the ultimate control of the democratic state applying the now-popular group idea to economic organisation

Socialism in present politics. *Influence of socialism on legislation and administration in modern States.*

Up to the present time, except in a few small and scattered communities, no attempts to apply the principles of socialism to their full extent have been made. No big and powerful modern state has adopted the complete programme of socialism, —Socialism is thus largely an ideal rather than an actuality. The only exception is Russia which has established a Socialist State under its present Bolsheviki rulers.

The socialist ideal however counts its adherents by millions in the modern civilised world, and it is exercising in an increasing degree great influence on the legislation and administration of almost all modern states. Socialists have great political influence in many continental countries (France, etc.) and they have become of considerable importance in England and the United States. Numerous reforms in social legislation have been either the direct work of socialism in politics or the indirect results of its influence. Workingmen's insurance, factory laws, industrial courts, tax reforms, the movement for a universal suffrage—all these things aiming at the improvement of the economic and the political condition of the masses have been influenced by the efforts of socialists. In the progressive countries of Europe and also in the United States, socialists by influencing public opinion have put into practice some of their administrative theories—and their activities include increased care for the poor, specially for children, extension of education, improved sanitation, popular concerts and theatres, together with the municipal control and management of waterworks, gasworks, street railways and other public utilities.

Recent developments of Socialism—Sovietism, Guild Socialism. Syndicalism.

Communism and Sovietism.

In a system of complete communism every individual will be allowed to take from the state everything that he needed. *All persons in the communist state would get payment not according to work but according to wants or needs.* It is clear that such complete communism is possible only in an extremely wealthy society where it would be possible for all persons to take from the state whatever they need for satisfying their wants. But even the wealthiest countries of the world to-day are countries of limited wealth and so communism at present is an economic impossibility; and many objections against socialism apply also to communism. *Russia is the only country that has seriously attempted to establish communism and it has failed—and †“in the strict sense Russia is communist no longer, in theory, and is settling instead to a regime of highly centralised collectivism, conducted according to the ordinary methods of accountancy, in the leading industries—textiles, transport, iron and steel and so forth—coupled with small-scale private enterprise in agriculture, and more or less strictly regulated capitalism in the other departments of economic life.”*

State provision of houses for the working classes or of other commodities and services at less than full cost or free may be regarded as examples of partial communism.

Sovietism is a form of Socialism. The Soviet Socialists of Russia, like other State Socialists, are for the national ownership of land and capital (as distinguished from private ownership); but the organization of industry under the Soviet system offers certain peculiar and characteristic features. *Each factory has its own Soviet or Committee.* “In Russia the powers of the Factory Soviet seem to have been conditioned from the first by the existence of the local Soviet, organised on a territorial and not on industrial basis. The real power of appointment and administration were gathered up in the hands of Moscow, while the formation of a centralised Trade Union for each industry constitutes a further check on the independence of individual groups of workers.”

Russian Communism and Sovietism for a time exercised considerable influence over Germany and Italy and even on the Clydeside Workers in Scotland. The visions of a Soviet Republic in Germany were crushed in 1919. In Italy attempts made in 1920 to establish Sovietism in the metal factories brought about the restoration of capitalism and indeed the establishment of Fascism.

Mr. Bertrand Russell comments unfavourably on Communism and Sovietism in Russia—“In spite of outward success the inner failure has

† Robertson—*The Control of Industry.*

proceeded by inevitable stages . . . by provoking the hostility of the outside world the Bolsheviks of Russia were forced to provoke the hostility of the peasants of Russia and finally the hostility or utter apathy of the urban and industrial population. These various hostilities brought material disaster and material disaster brought spiritual collapse. The ultimate source of the whole train of evils lies in the Bolshevik outlook on life; in its dogmatism of hatred and its belief that human nature can be completely transformed by force."

Syndicalism and Guild Socialism.

Syndicalism.

Pure Syndicalism is different from and indeed is opposed to Socialism for pure Syndicalism wants to destroy the State.

Syndicalism (originally known as Revolutionary Syndicalism), developed in France as a revolt against political Socialism. A large section of French labourers lost faith in political socialism as "many French politicians who have risen to power have begun their political career as Socialists, and have ended it not infrequently by employing the army to oppress strikers."

Syndicalism was originally the French name for Trade Unionism. The French Trade Unions became divided into two sections (1) the reformists and (2) the Revolutionary and it is this Revolutionary Syndicalism which has now come to be known as Syndicalism. The American Labour organisation known as the Industrial Workers of the World (commonly known as the I.W.W.) stands for American syndicalism.

The essential idea of Syndicalism is that in each locality the association of workmen in each trade is to control the means of production; and the good of the working class as a whole at the same time is not ignored for the local Syndicat (Trade Union) is not only federated with the Syndicats in the same industry in other places but it is also federated with the other Syndicats of other trades in its locality forming together the local Bourse du Travail. The Syndicalists desire to destroy the State as they think that the State is a capitalist institution terrorising the labour classes. They do not believe that the State will be much better even under State Socialism. And the Syndicalists therefore want that each industry should be self-governing and that means must be found for adjusting the relations between the different industries of the country.

Syndicalism has thus no faith in the State. And Syndicalism does not believe in political methods (constitutional and Parliamentary action) for realising its ends. Syndicalism wants a class war of Labour against Capitalism to be conducted by industrial rather than political methods. The chief industrial methods advocated by the Syndicalists are the strike, the boycott and sabotage (or the practice of doing bad work or spoiling machinery or work already done). The most important of the Syndicalist methods is the General Strike or a complete stoppage of

work by a sufficiently numerous body of labourers in different industries to secure the destruction of capitalism and the complete emancipation of the workers.

Guild Socialism.

Pure Syndicalism is not likely to be widely popular in Great Britain. In the words of Mr. Bertrand Russell "Its spirit is too revolutionary and anarchic for our temperament. It is in the modified form of Guild Socialism that the ideas derived from the C. G. T. (*Confédération Générale du Travail*) of France and the I. W. W. of America are tending to bear fruit in Great Britain."

Pure Syndicalists speak in rather scornful terms of Guild Socialism as the latest product of "the stupid middle class mind," "a cool steal of the leading ideas of Syndicalism and a deliberate perversion of them"; and they *protest against the State idea in Guild Socialism*.

British writers advocating Guild Socialism include men of considerable distinction like Mr. G. D. H. Cole, Mr. Bertrand Russell and others. Also some British writers have attempted to find historical analogies in the medieval craft system.

The Guild Socialists maintain that Guild Socialism is superior both to Syndicalism and Socialism. The Syndicalist claims everything for the industrial organisation of producers, the Socialist or collectivist everything for the territorial or political organisation of consumers, while the Guild Socialist attempts to safeguard the interests both of producers and consumers within the community.

According to Guild Socialism, each industry is to be self-governing and each factory is to be free to control its own methods of production by means of elected managers; and the different factories in every industry ought to be federated into a National Guild which will look after marketing and the interest of the industry as a whole. Each Guild is to decide as to how the collective Guild income is to be distributed among the members. The liberty of the producers and their economic interests are properly safeguarded by this self-government in industry; and the liberty of the labourers and self-government in industry and also the resulting economic efficiency would not be secured at least to this extent under ordinary Socialism or Collectivism.

At the same time Guild Socialists declare that Guild Socialism will protect the interests of the consumers through the instrumentality of the State. "The State would own the means of production as trustee for the Community; the Guilds would manage them, also as trustees for the Community, and would pay to the State a single tax or rent. Any Guild that chose to set its own interests above those of the community would be violating its trust, and would have to bow to the judgment of a tribunal equally representing the whole body of producers and the whole body of consumers. This joint committee would be the ultimate Sovereign body, the ultimate appeal court of industry. It would fix

not only Guild taxation, but also standard prices, and both taxation and prices would be periodically readjusted by it."

In the Guild Socialist plan the State is regarded as consisting of the community in their capacity as consumers and the Guilds are regarded as representing the community in their capacity as producers and so the Parliament of the State represents the consumers and the Guild Congress represents the producers as a whole and they are to have equal power; and above both is to be a joint committee of the Parliament and the Guild Congress for settling matters involving the interests of both consumers and producers.

The practical difficulties of Guild-Socialism are in connection with the settlement of the conflicting claims of different Guilds and also the conflicting claims of both the producers and consumers. Variety of proposals among the Guild-Socialists themselves as regards the fixing of prices and the disposal of surplus indicates the inevitable difficulties in connection with conflicting interests.

Co-operation.

Co-operation aims at a complete programme of social reconstruction. Though directly descended from the Associationist socialism of the first half of the 19th century, *it is not strictly socialistic* because it would retain private property with its principal attributes. *Yet it seeks to realise some of the most important objects of socialism*, and it is doing an immense amount of good to persons practising it.

For different kinds of Co-operation, see Part I, pages 326-330.

Right of private property.

While discussing socialism and other schemes of social reforms, the right of private property comes in for criticism and examination.

(1) Theory of Natural Right.

The upholders of this theory maintain that property is a natural right. But if property is a natural right, what are we to say to those persons who have no property and demand it? The aim of social science must be to see that each man has a minimum of property.

(2) Labour theory.

An attempt has been made by the classical economists and other persons to prove that *labour* is the basis of property. A man should own all things he has created by his labour.

Objections. The theory is not applicable to actual conditions because (i) portions (and often considerable portions) of a man's property are due to inheritance and other causes and not due to his labour; (ii) the labourer is not the owner of the product he produces by labour,—the product belongs to the employer.

In reality, the right of private property like all other social rights must be examined from the standpoint of social welfare, and must be limited and regulated from that standpoint.

Standard of Life and Standard of Comfort. Progress in relation to Standards of life.

What is the connection between changes in the manner of living and the rate of earnings? How far is either to be regarded as the cause of the other and how far the effect? This is a question of the greatest importance in our present generation.

In this connection, Marshall takes the *standard of life* to mean *standard of activities adjusted to wants*. "A rise in the *standard of life* implies an increase of intelligence and energy and self-respect ; leading to more care and judgment in expenditure A rise in the *standard of life* for the whole population will much increase the national dividend, and the share of it which accrues to each grade and to each trade. A rise in the *standard of life* for any one trade or grade will raise their efficiency and therefore their own real wages ; It will increase the national dividend a little. . . ."

To Marshall the *standard of comfort* is a term that may suggest a mere increase of artificial wants, among which perhaps the grosser wants may predominate. A rise in the *standard of comfort* will probably involve some rise in the *standard of life* ; and in so far as this is the case, it tends to increase the national dividend, to raise wages and to improve the condition of the people. A mere increase of artificial wants which does not increase activities and which does not raise the *standard of life* in any way only makes people more miserable than before ; an increase of wants which does not raise the *standard of life* cannot raise wages, except by diminishing the supply of labour.

For Progress in relation to standards of life see Marshall —Principles, Chapter XIII.

(There are some writers however who use *standard of life* and *standard of comfort* as synonymous expressions).

Standard of comfort in India.

The elements entering into the *standard of comfort* of the working class in a country include (a) food, (b) clothing, (c)

house-room, (d) heat and light, social expenses, some amount of amusement and recreation, insurance and education etc. The standard of comfort may be analysed into (i) necessities, (ii) decencies and (iii) luxuries.

In India the standard of comfort of the working class is very low. The food is generally poor in quality, insufficient in quantity, and there is comparatively little variety. The clothing is also insufficient specially in the winter, and the workers are housed in wretched, ill-ventilated, insanitary hovels. They have few amusements, and generally they have not the means to spend anything on education and other higher wants, labourers in industrial towns are sometimes somewhat better off than agricultural labourers—but for all of them a large rise in the standard of comfort is required to secure a happy and prosperous population. (It is essential for true progress that a rise in the standard of comfort should be accompanied by a rise in the standard of life ; and for bringing about this rise, a wide diffusion of education is urgently and immediately required).

Progress in the future.

Economic progress in the past indicates to some extent the conditions upon which the economic progress of the future must depend. Changes in habits of consumption which will increase the satisfaction derived by men from goods and lessen the cost of production must continue to be made ; methods of production must be further perfected by improvement in the capital goods used, by fuller utilisation of the forces of nature, by an increase in the fund of capital, by better organization of industry, and by steady improvement in the efficiency of the working population ; the distribution of the social income must be so changed as to give a larger share of the product of industry to the working class.

Labour unions and labour laws must continue to help the working classes in the struggle for improving their economic condition. Monopoly should be regulated in the interest of social welfare and to enforce fair competition. There should be tax reform. Public revenues must be drawn in an increasing

measure from the incomes of those who can best afford to contribute to the common fund for the common welfare. These are all reforms for the present and the immediate future and (unlike socialism) can be immediately brought into operation. *And economic progress as, progress of all kinds ultimately depends upon the individual, upon the character and capacity of the average citizen* and unless he responds to the efforts made for his betterment, there is no prospect of permanent progress.

The greatest war in history is over. The World Economic Depression—the greatest and most stupendous in history—is still with us. The world, political and economic, has received shattering blows. Yet hope is not dead. The New World is to come—mankind waits for it. Throughout Europe and America, the masses have awakened to a new sense of their rights and their power—Bolshevism in Russia, Syndicalism growing in France, in the United States, in conservative England peaceable and constitutional labour movements which no longer seek only higher wages, better conditions of work but also some sort of control, they all in different degrees testify to this growing consciousness of rights and power. The State at present is largely an economic and political oligarchy in substance and spirit—a New State has to be created for all, for thinkers, artists, workers, broad-based on the free energies, strong will and character of a generous, large-visioned people.

APPENDIX A.

War Problems and After-War Problems. War Finance. The cost of Inflation. War Debts and Reparations. Soviet Economics and the Five Year Plan. The World Economic Depression.

Some acquaintance with the important economic questions relating to the period of the World War (1914-1918) and the post-war period of great stress and strain still continuing has its high practical interest to every student of economics—not excepting the beginner in economics, for whom this book is primarily intended.

Fundamental economic principles have been severely tested during these years—much more severely than in any previous period. They have stood the test remarkably well. In the fields of currency, banking, international trade, national taxation and national expenditure, existing ideas and theories have needed modification, adaptation to new and changed conditions and sometimes extension. But their essential correctness in most cases has been all the more strongly confirmed. Economics has abundantly justified its claims to be recognised as a science—though not a science of a very high degree of exactness.

Short references to War Problems and After-War Problems are given below:

War Finance.

The War started in 1914. "Honour is the subject of my story" said the general, said the politician in every warring country. The patriotic passion was torn "to tatters, to very rags". After a vast amount of "pride, pomp, and circumstance of glorious war", the war-shattered world, lay economically prostrate, almost in ruins.

The governments of the countries, engaged in the Great World War—Britain, France, Germany, Austria-Hungry,

Russia, United States, etc.—had to raise huge unprecedented sums to meet the vast war expenditure as the War progressed. A government engaged in the War could meet the war expenditure (a) partly by increasing taxation, and as there was a limit to it, (b) largely by borrowing from its own nationals, also from the nationals and the governments of other countries. (*For respective merits of taxation versus borrowing relating to war expenditure, refer to pages 473-474.*)

A government could borrow from its own nationals (I) genuine savings made by them and (II) also supply of purchasing power provided by inflation.

In the United States and Britain, inflation producing excess supply of purchasing power was provided by (1) expansion of bank deposits and (2) excessive issue of practically inconvertible paper money by government and by banks. The banks expanded their deposits and thus provided funds for (a) direct loans by banks to government, (b) loans by banks to citizens to enable them to lend to government by buying war-loans.

Every country engaged in the war—Britain, the United States, France, Germany, Italy, Russia, etc. issued paper money to excess. In France bank notes only were used; Great Britain, Italy and Germany used bank notes as well as government paper money. The result was great inflation in these countries. By the end of 1918 prices in Great Britain were thrice as high as before the War; in France the rise in prices was four-fold and in Italy five-fold.

The cost of inflation.

When a government borrows the *genuine savings* of its nationals, the lenders have less of purchasing power and the government has more.

When there is inflation creating excess supply of purchasing power through (a) expansion of bank deposits, (b) excessive issue of inconvertible paper money, new purchasing power is created without the making of any new genuine savings by the citizens. As a result of inflation the government gets additional supply of purchasing power, but it seems that the

citizen loses nothing as he is lending no new genuine savings to the government. In reality the citizens have to pay and pay heavily to enable the government to get additional supply of purchasing power through inflation—*What is the cost of inflation to the citizen?* Inflation raises the price-level (prices of commodities in general) in a country, and thus reduces the value of money in the hand of every citizen—*Inflation taxes the citizen by reducing the value of the money held by every citizen and not by reducing its amount.* Suppose in a country inflation raises prices four-fold as high as before the War. This reduces the value of money in the hand of every citizen to one-fourth of its pre-war value. Inflation seems thus to be a proportional tax—but in reality “on balance, inflation is likely to increase the inequality of incomes and operates, in effect, not as a proportional, but as a *regressive tax*. This consideration alone limits the desirability of inflation as a means of raising revenue”. In a period of inflation and rising prices, prices of all commodities and services do not rise equally. The incomes of business men rise more than in proportion to the rise in prices; wages rise but do not rise in proportion; fixed incomes do not rise. So inflation “causes a redistribution of income in favour of business men, who secure large windfall profits, at the expense of wage-earners and, still more, at the expense of the recipients of fixed money incomes.”—Dalton, *Public Finance*.

Inflation in relation to (a) National Distribution, (b) National Production, and (c) Government Revenue.

Inflation by bringing about a redistribution of income in favour of rich business men at the expense of the poorer wage-earners and also at the expense of the classes with fixed incomes, is open to serious objection from the point of view of *national distribution*.

As regards national production, inflation, so long as it is moderate and brings about a moderate rise in prices, is regarded to be a stimulus to production encouraging business men by increasing their profits. But it is only a temporary stimulus and often the ultimate effects are serious and disastrous. The continuance of inflation to any great extent reducing the value

of money continually and greatly, destroys the confidence of business men and the whole nation in the future value of their currency. There is "the flight from the currency". People become eager to get rid of money which is depreciating continually and greatly and the fall in the value of such money, both internal and external, is sharp and continuous. "Under such hectic conditions, which have already come to pass in several European countries, organised production becomes impossible and all economic transactions, other than by primitive barter, are reduced to a wild gamble. Economic chaos, political upheavals and, perhaps, violent revolution are then not far away."—Dalton, *Public Finance*, 1926, Third Edition, pp. 139-40.

As regards government revenue, a government in financial difficulty and specially in war-time, resorts to inflation when it is not in a position to tax straightforwardly or offer sufficiently high rate of interest to attract sufficient supply of new savings. But as inflation proceeds beyond a certain point and there is a "flight" from the currency the value, per unit, of paper money falls much faster than the supply increases. This increases the difficulty of the government to get adequate funds in this way.

War-Debts and Reparations.

As a result of the War, America became the creditor of all the allied countries—Britain, France, Italy, etc.—for sums advanced by America to carry on the War. In this way Britain also became the creditor of her European allies. These are the *inter-allied war-debts*. Vanquished Germany had to agree to pay *reparations* to the victorious allies.

"The Great War left the world in a state of indebtedness which is unparalleled both as regards the absolute size of the Government obligations and the extraordinary complexity of the international arrangements.

During the war years the greater part of the international debts arose out of loans between the allied states. After the Peace a new factor was added by the obligations imposed on Germany by the Treaty of Versailles, which have since been sub-

jected to modification and which still have probably not taken their final form. As the position at present stands on paper: America has enormous claims on this country and on all the European Allies, amounting in all to sum \$11,000 m. England has her debts to the U. S. A. and some other smaller obligations amounting to about £1,200 m., or just about twice the total of her pre-war National Debt. She has large claims on the European Allies for War-Advances (more especially on Russia; France and Italy), and a considerable claim on Germany. Her external obligations (even after allowing for the defalcation of Russia, her largest individual debtor, and apart from her claims on Germany) are more than offset by the debts owed to her from abroad. France, Italy and Belgium are faced with their liabilities to England and the U. S. A. against which they, and more especially France, have large claims on Germany, while Italy has some rather shadowy claims on Austria. This is, of course, not a complete account, but it gives some idea of the complexity of the position."—Robinson, *Public Finance*, 1928, pp. 136-137.

Evil effects of war debts and reparations payments to countries paying them and receiving them.

A country paying reparations or repaying war-debts (the funds borrowed being already exhausted in the work of destruction and not of production) gets no commodity or services in exchange and is thus definitely poorer to that extent. Such a country making this payment by the excess exports of goods to the country receiving such payment, will damage the domestic industry of that country or by sending these excess exports to other countries, will increase competition in those markets and may in that way cause damage to the exports of the country receiving payment. The necessity of having such excess exports and forcing them on the markets of the world depresses world prices and is one of the causes of the world economic depression.

These inter-allied war-debts and reparations have caused great damage to the world economic system and to countries paying and receiving such payments. Refer to the World Economic Depression, page xviii.

Competent economists and enlightened public men in all countries are coming to realize increasingly that these war-debts and reparations are in important degree responsible for the world economic depression, are standing in the way of world recovery ; and *a complete cancellation of such war-debts and reparations is in the best interest of all parties concerned.*

As a matter of fact there is an end of reparations so far as Germany is concerned. No German government promising to continue reparation payments will be able to maintain itself in Germany. One of the many failures of the World Economic Conference held in 1933 was that it was not allowed to discuss the question of allied debts to the United States of America for the purpose of finding a solution. Britain and some countries are still paying instalments of their debts to the United States of America. It is doubtful how long they will continue to do the same.

Mr. Lloyd George on

(1) *The connection between reparations and war debts :*

"In solid reality and in practical experience, these two forms of liability are closely similar and vitally connected.

Both reparations and war-debts were liabilities incurred as the inevitable result of military operations. They are both inseparable from war. They did not represent in either case the bill for solid additions to its national capital which had been received by the debtor country

As a matter of historical fact, all repayment of war debts actually made by the Allies (except the earlier payments by Great Britain to America) have been made out of their receipts from reparations."—*The Truth about Reparations and War-Debts*, pp. 101-102.

(2) *The burden of internal debt as distinguished from the burden of external debt of a country (in connection with war-debts and reparations) :*

"A sharp distinction must be drawn between the problem of Reparations and War-Debts which have to be settled across the frontier and those which are internal. A country's internal debt is owed by the Government to its own nationals and is settled by the simple process of taking from all nationals in taxation what is paid out to a large number of them in dividend and amortisation. I will not here enter on a discussion of the debatable question of the precise extent to which these internal liabilities involve a definite loss to the country which incurs them, either in respect of the unproductive waste of material and human effort in which the sums they represent were expended or through their fostering fresh expansions of the rentier class, on a scale which

may make it injuriously parasitic upon the workers. It will suffice to point out that they do not necessarily affect a country's financial status *vis-à-vis* other nations, although they involve a certain measure of redistribution of purchasing power between its own citizens. *"But the payment of debts or reparations across the frontier implies a definite impoverishment of the nation to the full extent of the amount handed over.* Experience has also shown that grave embarrassment is suffered by the trade of the creditor country which is required to receive either manufactures which it would normally produce itself, or gold, which must lie heaped up unproductively in its strong rooms with disastrous effect on the credit and currency position throughout the world"—Lloyd George, *The Truth about Reparations and War-Debts*, 1932, p. 80.

Soviet Economics and the Five-Year Plan.

The War produced many important economic and political changes. One such change of remarkable importance is the establishment of the Soviet Republic in Russia attempting to carry out the economic and political programme of socialism, largely under the inspiration of the teaching of Karl Marx. Britain, the United States, Germany, France, Italy, Japan, all follow the capitalistic (and competitive) economic system and base their political organisation on the economic foundation of capitalism. Among leading countries Russia alone in practice follows socialism and communism.

The first Five-Year Plan of the Soviet Republic for the economic modernization of Russia (specially as regards heavy industries, manufacture of machinery, etc., though including also large programmes for agricultural development) started operations in the year 1928-29.

The following extracts from Grinko's *The Five-Year Plan of the Soviet Union* give some impression of the ideas of the Soviet leaders as regards their economic programme in general and the Five-Year Plan in particular.

"The great task set by the Five-Year Plan for the development of the productive forces of the Soviet Union through rapid industrialization and steady strengthening of the socialist elements in national economy, is that of attaining and surpassing the technical and economic level of the advanced capitalist countries, thus assuring the triumph of the socialist system in its historic contest with capitalism.

"For, indeed, what are the essential prerequisites, the essential foundations on which the planned organization of Soviet economy develops in spite of colossal difficulties? They are as follows:

1. The establishment of the dictatorship of the proletariat; that is, the destruction of the bourgeois state machine from top to bottom and the concentration of state power in the hands of the proletariat, which then becomes the organizer and leader of the national economy.

2. The nationalization of the land, factories, workshops, railroads, banks, etc., and the organization and systematic extension of the sphere of socialized production.

3. The monopoly of foreign trade and the strict regulation of economic relations with the capitalist economy of the world, with a view of bringing them fully into accord with the plan for the construction of the socialist economy.

4. Undeviating limitation and the final elimination of the capitalist, exploiting elements in the villages—the Kulaks;* the widest scope of development for the small and middle or toiling individual peasants; the greatest possible stimulation of their productive efforts by the State and at the same time systematic preparation of the conditions necessary for the progressive transformation of small and middle peasant husbandry into large-scale socialized agricultural production by means of wholesale collectivization, state farms, tractor and machinery stations, etc.

5. The essentially different attitude, as compared with capitalist society, of the Soviet economic system, and hence of the Soviet State in general, toward the proletariat, peasantry, national minorities, backward regions, etc.

6. The fact that the great masses of the proletariat, agricultural labourers and poor peasantry, and the bulk of the intellectuals are deeply and vitally interested in the success of the socialist economy and the resulting increasing self-activity

* Literally "fist"; a wealthy peasant exploiting hired labour and acting as the village usurer; represents the remnant of capitalist and anti-Soviet element in the village.

WAR PROBLEMS AND AFTER-WAR PROBLEMS' ix

of the people. This radically distinguishes the principle of Soviet economic construction from the economic processes taking place under conditions prevailing in antagonistic bourgeois society.

7. Finally, the ability peculiar to the Soviet system, to concentrate at any given moment, under the guidance of a single thought and will, on the most important sectors of the general line of economic construction virtually all the combined resources of the State, the monopolistic political party, the trade unions, the peasant organizations, the state trusts, syndicates, banks, the co-operatives, the press, schools, etc." —Grinko, *The Five-Year Plan of the Soviet Union*, Third edition, 1931, pp. 31, 12-14.

As regards the economic, moral and political results of the Soviet system in general in Russia and the Five-Year Plan in particular, opinions differ widely among economic and political thinkers in other countries.

Mr. Calvin Hoover writing in the *Economic Journal* in September in 1930, makes the following observations:

"It has long been recognized that the problem of how to induce enough saving to maintain and expand capital equipment would be one of the most difficult problems which would face a Socialistic regime. . . . The record of capital investment in the Soviet Union for the last couple of years has proved that expansion of capital equipment can take place within a Socialistic economy. Seldom has so large a proportion of a nation's income been saved and devoted to capital construction.

"Not only has the Soviet economic system demonstrated that adequate saving of capital can take place in a Socialistic economy, but the evidence so far available indicates that the technique of mass production can be transferred from Capitalist countries to Soviet Russia.

"At the present time the Soviet system is still far behind the Capitalistic system in industrial efficiency. It is possible that its technical productivity will never have the potentialities of the Capitalistic system.

"But one must admit that Soviet Russia is further removed from Utopia than is the Capitalistic civilisation." In Soviet Russia there is not less bitterness, but more. Communism has not brought peace to Russia, but instead a sword. Some part, at least, of the energy which men of ability in the Capitalistic world expend in amassing wealth is in Soviet Russia canalised in the struggle for power. Within the State Trusts and Commissariats, within the Party, the struggle for power is sharper than within the institution of Capitalism. . . .

"Never in history have the mind and spirit of man been so robbed of freedom and dignity. It is not merely that academic freedom, freedom of speech, freedom of the Press, and freedom of thought are forbidden. The party is not content with mere abstention from unauthorised action. Men must publicly deny their real thoughts and feelings."

THE WORLD ECONOMIC DEPRESSION (1929) THE FINANCIAL CRISIS (1931)

World Economic Recovery after the War.

The War was finished in 1918.

No one hoped that a world, shattered economically by four years of war, would be able to make a quick recovery. But in 1929, only about ten years after the end of the war, not only the world as a whole, but even Europe, had a higher average standard of living than in 1913. This was a great, a wonderful recovery.

Then came the depression.

The World Economic Depression.

Since 1929 we have the world economic depression—some call it the world economic crisis.

It is a *world economic depression* (1) as its *evil effects* relating to depression of prices, production, employment, international trade, impoverishment of nations and governments extend to all countries of the world, (2) as its *causes* are world-

wide and the *remedies* also must be not merely national but international, and (3) the effects and causes are *chiefly economic* though not without very important political and social consequences.

Effects.

We find prices of commodities—agricultural crops, manufactures, minerals—have fallen heavily in all countries of the world. With fall in prices producers in every country and all countries have suffered losses, reduced wages, have dismissed millions of labourers. Prices of agricultural commodities have fallen more than the prices of manufactured commodities. So agricultural countries, like India, have been harder hit. Many producers have been bankrupted. Labourers have suffered wage-cuts. Twenty to thirty millions of labourers all over the world are unemployed* and suffering very serious hardships. A certain proportion of unemployment is due to technological improvements and the rationalisation of some industries which can now produce the same or a greater output with much fewer labourers than before. With extensive unemployment and reduced purchasing power of the masses of the people, production in many industries has declined. World trade has declined substantially. With falling prices and rising value of money the burden of debt of business men and debtor countries has increased to an oppressive extent. All debtor nations are suffering. In particular agricultural countries find great difficulty in meeting interest and other charges of the creditor

* "The Director of the International Labour Office, in his annual report presented to the 1932 Conference, estimated the number of totally unemployed in those countries for which information of some sort was available at the end of 1931 as 20-25 millions. It is a depressing deduction from this estimate that some 60 to 70 million persons, mainly in the highly developed and richer countries of the world, "are deprived of the means of existence arising from their own activity or that of those on whom they are dependent."—*World Economic Survey*, 1931-32, pp. 243-244.

"The total value of world trade decreased by about 19 per cent in 1930. In the following year, added restrictive forces came into play, so that the *quantum* of trade diminished further by about 23 per cent and prices also declined so that the total value fell to still lower levels."—*World Economic Survey* 1931-32, pp. 243-244 and p. 154.

countries, have to sell more of their agricultural produce at falling prices to make these payments and with reduced purchasing power are able to purchase less of the manufactured products of the creditor and manufacturing countries. The international gold standard has been abandoned by almost half the world, including Britain and the countries of the British Empire and the United States of America. The nations of the world have been impoverished. So also the governments. Most of them have heavy budget deficits, and are trying desperately to improve their financial position by desperate measures like restrictions on foreign trade and the unhappy expedient of curtailing expenditure on the social services.

The Course of the World Economic Depression.

"After the break on the New York Stock Exchange in October 1929, a rapid fall of prices set in, which strengthened the already existing depression in the raw-material-producing debtor countries and gravely aggravated the already declining productivity in most industrial countries. also. . . .

"The dominant factor in the deepening economic depression of 1930-31 was the collapse of agricultural and raw-material prices. The prices of finished manufactured products were relatively well sustained; but there was a precipitate decline not only of foodstuffs, such as wheat and coffee, but also of many important minerals such as copper. For a time, animal products were less affected than the cereals, and it was noticeable that the countries where animal products were important remained relatively prosperous till towards the end of the year 1930. . . .

"This wholesale decline in agricultural and mineral prices in 1930 is treated in more detail later. It was caused by two main factors operating in the more rigid economic system of the post-war period. During the boom period, many, if not most, of these commodities were maintained at relatively high price-levels and production was extended behind the shelter of control or valorisation schemes financed at increasing cost. . . . Production had been extended, stocks were piling up and prices were already tending to fall, when higher interest rates followed by the collapse of the security boom swept the credit basis from under the control schemes.

"The second main factor in depressing the prices of raw materials and foodstuffs is the dwindling of capital export already noted. From the latter half of 1928, the total supply of capital available in the main creditor country, the United States, fell off steadily. The debtor countries were thereby seriously embarrassed in the settlement of their international balances. They had come to rely upon large annual

borrowings as a means of "bridging the gap" between their income and outgo. . . .

"The fall in the prices of agricultural products reduced the incomes of the debtor countries and enormously increased the real burden of their debts. The pressure of their obligations in turn necessitated both heavy taxation and banking policies directed to securing the necessary foreign exchange for the service of external debt. Such measures further depressed the commodity markets. As prices fell, production was increased in a desperate effort to attain the same income. Heavier export surpluses were thrown on world markets. At the same time very strong measures were taken to restrict imports, and particularly to protect the peasant production of European countries.

"The deepening of the economic crisis throughout the latter months of 1930, therefore, was due largely to the accumulating difficulties of the debtor countries, and particularly of those among them which relied primarily upon exports of raw materials and foodstuffs. There were many complications, perhaps the most important being the continued attraction of the French short-term balances back to France and the imposition of the Hawley-Smoot tariff. The former was accompanied by a continued drain of gold to France, and not only weakened the financial position of other gold-standard currencies, but hindered any large possibilities of renewed long-term capital exports from the United States and Great Britain. The latter still further hampered the free exchange of commodities by which alone the heavy payments on account of debt service might have been achieved.

The Financial Crisis, 1931-32.

"In the spring of 1931, as in the spring of 1930, there seemed to be a definite easing of economic and financial conditions. The early months of the year were calm, there was some return flow of capital to Germany and of gold to Great Britain, security prices rose somewhat in most countries in the spring, and money-market rates were extremely easy in the chief financial centres.

The plight of the borrowing countries, reinforced by their failure to secure new capital imports, was inevitably reflected in considerable shrinkages of their national incomes and purchasing power. This caused a further decline in their imports and neutralised the possibility of industrial revival in the creditor countries, whose conditions were further affected by the steadily growing volume of unemployment. . . .

In May 1931, while money rates were still easy and there was still some measure of faith in a speedy recovery from the depression, a large Austrian bank, the *Creditanstalt*, disclosed heavy losses. The importance of this news from Vienna, which travelled round the world's financial centres like a seismic shock, lay less in the event than in its general significance. It was instantly realised that, not only other banks in Austria and foreign countries, but virtually the whole industrial structure of Austria, and other Eastern European countries, would be involved.

The Abandonment of the Gold Standard.

Great Britain's difficulties were connected both with Germany's and with those of Central Europe, which were very much aggravated by the run on German banks. . . . It was known that British bankers had lent, not only Germany, but other Central European countries, a large amount of short-term credit which was rapidly becoming "frozen" by the inability of these countries to meet their foreign obligations. The Macmillan Committee, in its report published on July 13th, had drawn attention to the volume of short-term claims on London. . . . On July 31st, the May Committee published its report upon the condition of the public finances, and for the first time there was general realisation of the probability of a large deficit, estimated at £120 million. The Cabinet disagreed on proposals to balance the budget, and on August 24th the National Government was formed.

At the beginning of August, the Bank of England had secured a credit of £50 million from French and American banks, with which to withstand the drain on the gold reserves caused by the withdrawal of short-term balances and the sale of British securities. On August 29th, a further credit of £80 million was arranged by the Treasury; but the drain continued. Over £200 million was withdrawn from the London money market in the two months preceding September 20th. A supplementary budget imposing heavier taxation was introduced on September 10th as a measure of financial reform; but on the 15th, a protest by naval ratings in the Atlantic Fleet against pay reductions was given wide publicity. The run on London rose to extraordinary proportions. . . . On September 21st, therefore legislation was passed suspending the Bank of England's obligation to sell gold.

The repercussions of the fall of the pound were more serious immediately. The first effect was to cause the abandonment of the gold standard by a number of other countries which were in close relationship with Great Britain. The Argentine and Uruguay had suspended gold payment in December 1929, Canada had introduced restrictions on the gold standard at the end of 1929 also, and in 1930 the exchanges of Brazil, Chile, Venezuela, Paraguay, Peru, Australia and New Zealand fell and remained below export gold point. After Great Britain's action, the number of countries off gold was greatly increased. Before the end of October 1931, all the British Dominions (except South Africa), the rest of the British Empire, and the three Scandinavian countries, as well as Portugal, Egypt, Bolivia, Latvia and Finland, had departed from gold. Japan followed in December 1931, Greece in April and Spain and Peru in May 1932.

. . . . The financial storm burst with redoubled force on Germany, which on November 19th applied to the Bank for International Settlements for the convocation of the consultative Committee provided for by the Young Plan. . . .

Before the acute stage of the panic passed, however, New York was

Sometimes the monopolist charges a price lower than that yielding the maximum net revenue.

(1) *Low price to stimulate demand with a view to the future development of his business.*

1. In certain cases, a monopolist will charge a price which is less than the price yielding him the maximum net revenue; and he will charge a low price with the idea that the low price will greatly increase the demand for his commodity in future, and this will compensate him for his present loss. A gas company will sometimes reduce the price of gas with this object and a railway company will reduce its freight rates to a port to stimulate the prosperity of the port and thus to bring about increased traffic for the railway in future.

(2) *Low price to increase consumer's surplus.*

In other cases a monopolist will charge a lower price than the price yielding the maximum net revenue, he will sacrifice a portion of his net revenue with the object of increasing consumer's surplus. This is often done by public bodies, e.g. by municipalities fixing the prices at which they will supply gas or water, and by the state fixing fare rates on the state railways, etc.

Monopoly and consumer's surplus.

A monopolist may regard consumer's surplus as of equal importance with his net revenue, he may look upon one rupee's worth of consumer's surplus and one rupee's worth of monopoly revenue as equally valuable. The sum of monopoly revenue and consumer's surplus on this plan is called by Marshall *total benefit*. Obviously the monopolist in this case will fix the price of the commodity in such a way as to make this total benefit the largest possible. The *total benefit price* is clearly lower than the price which produces for the monopolist the largest possible net revenue out of his monopoly.

A more frequent case will be the following: the monopolist may not look upon consumer's surplus and monopoly revenue as of equal value, and may regard consumer's surplus as of somewhat less value. Suppose as regards a particular monopoly the monopolist counts consumer's surplus at a fraction of its actual value, he looks upon one rupee's worth of consumer's surplus as equivalent to 4 annas of monopoly revenue. The sum of the monopoly revenue and $\frac{1}{4}$ of the consumer's surplus on this plan is the *'compromise benefit'*; and the monopolist in this case will fix the price of the commodity in such a way as to make this compromise benefit the largest possible. The *'compromise benefit price'* is lower than the price which produces for the monopolist the largest possible net revenue out of his monopoly.

The following general results are important.

(i) First the amount which the monopolist will offer for sale will be greater (and the price at which he will sell it will be less) if he

is to any extent desirous of promoting the interests of consumers than if his sole aim is to obtain the greatest possible monopoly revenue.

(ii) Secondly, the *amount* produced will be greater (and the selling *price* will be less) the greater is the desire of the monopolist to promote the interests of consumers.

Taxes and bounties on monopolies.

See Taxation—Book V.

CHAPTER VII.

SPECULATION.

In the settlement of market prices, speculation is an important factor.

Persons buying and selling a commodity with a view to make profit from the differences between present and future prices of the commodity are said to speculate in the price of the commodity. There is always a great deal of speculation as regards important commodities, (*e.g.*, wheat and other food grains, jute, cotton and other important raw materials, steel and other metals useful for industrial purposes, etc.) in the developed markets of the world. Also we have a great deal of stock-exchange speculation in shares of companies and in the public debts of modern states.

Two classes of speculators.

We have to distinguish between two classes of speculators.

- (1) *Professional speculators.* These are shrewd business men who have made speculation their business, and who on account of their superior knowledge and foresight are able to forecast with considerable accuracy changes in supply and demand and consequent changes in price in the future ; they regulate their purchases and sales according to these forecasts—and the greater the skill of a speculator in forecasting the larger will be his profits.

(2) *Mere amateurs.* Persons belonging to the ill-informed outside public also speculate without possessing any knowledge or skill in making reasoned forecasts about future changes in demand and supply, and consequent changes in prices; they do this in a gambling spirit, and they often follow false prophets who make wrong forecasts.)

It will be seen below that skilled professional speculators engaged in honestly anticipating changes in demand and supply benefit themselves, and what is of much more importance confer great benefits on society; but that speculation by ignorant, unskilful persons belonging to the lay outside public injures these foolish gamblers and also injures society as a whole.

Economic function of speculation.

(The proper economic function of speculation is to promote the establishment of equilibrium of demand and supply in the market and thus to help on the smooth course of consumption, production and exchange. This speculation does by steadying prices, and thus it enormously helps and benefits society.

The speculators take the risk of anticipating changes in demand, supply and prices; they stabilise (i.e. steady) prices and thus benefit society; and they benefit themselves by their profits.

Capable businessmen, with a high degree of knowledge and skill in forecasting changes in demand and supply, by their operations exercise a steadying influence on prices. When these skilled speculators calculate that price is going to rise in future, they buy at once for future use: there is thus a rise in price in the present, and the rise in price in future is not so great and so sudden as it would otherwise be. Again when these skilled speculators calculate that price in future is going to fall, they restrict their purchases in the present, as much as possible and decide to buy in the future when price has fallen; the restriction of demand in the present brings about a fall in price in the present, and the transfer of part of the present demand of the speculators to the future makes the fall in price in the future less considerable and less sudden than it would otherwise be.

Skilled speculators thus by anticipating changes in demand and supply and consequent price changes, help to adjust present demand and supply to anticipated changes in these things, and thus prevent large fluctuations in prices—they thus steady prices.

This is healthy speculation because it not only benefits the speculators by giving them profits, but it very considerably benefits society.*

The advantages derived by society from the steadying of prices brought about by speculation are the following:—

(i) *Consumers of the commodity* (if the commodity is a consumption good) *are benefited.*

(a) A steady price for the commodity (supposing the purchasing power of money remains constant) means that the supply of the commodity is properly adjusted to the demand; and when the supply is properly adjusted to the demand, a maximum of satisfaction will be realized by consumers. Fluctuating prices mean imperfect adjustment of supply and demand and consequent loss of satisfaction to the consumers.

(b) Among the beneficial effects of speculation may be also mentioned the fact that *speculators by their action draw the attention of the public to a future shortage of supply of a commodity*, and thus lead the public to be more economical and less wasteful in their consumption of the commodity. This is a great gain when the commodity is an important one, e.g., food-stuffs, coal, etc.

(ii) *Producers using the commodity as a raw material for their industry are benefited.* *Speculators by reducing the fluctuations in prices of the raw materials diminish the uncertainties of business for the producers, and reduce their risks of loss.* The manufacturers of cotton or woollen or steel goods.

* "The speculator's object is to make a profit when prices are rising but he can do so only by mitigating the rise. Likewise his object is to make a profit when prices are falling, but he can do so only by mitigating the fall. His profits are as if were a reward paid him by the community for mitigating price changes." (Fisher—*Elementary Principles*, Chapter xviii). That is healthy or legitimate speculation in which the gains of the speculators are earned by some service to society.

can buy their raw materials at comparatively stable prices, and at any time they like and all through the economic activities of the speculator class.

Again producers agreeing to sell their products(e.g. cotton manufactures) to purchasers at agreed prices on agreed future dates enter into arrangements with speculators as regards the supply of the raw material (e.g. cotton) at agreed prices at the times required ; and so they make sure a profit for themselves. They transfer the risk of a rise in the price of the raw material from their own shoulders to those of the speculators.

Evils of speculation—economic abuses attaching to unhealthy forms of speculation.

Speculation has its economic function, also its economic and other abuses.

It benefits society when it lessens fluctuations of the prices of commodities and it injures when it increases these fluctuations.

There are certain *unhealthy forms of speculation which are harmful to society*—(i) *Amateurs*. When ignorant and unskilful persons under the influence of wild rumours or following false prophets gamble about the prices of commodities, there are often violent fluctuations in prices, prices often become too high or too low, society loses by these large fluctuations and these ignorant speculators by their too frequent mistakes in calculations will themselves more often lose than gain.

(ii) *Professional speculators*. When expert professional speculators instead of engaging in the honest work of intelligently anticipating future natural movements of demand and supply, artificially alter prices to fill their own pockets they become a curse and an abomination. . A man who *corners* (i.e. dominates the supply of) wheat or any other important commodity, and by thus monopolizing the supply increases the price artificially and makes enormous gains at the expense of the consumers—such a man is doing society a great injury.

There is also the grave moral injury from the fostering of the gambling spirit by unhealthy speculation.

(It is seen that these unhealthy forms of speculation tend to unsteady prices ; in modern developed markets, the total influence of these unhealthy forms of speculation is perhaps of less importance in comparison with that of healthy speculation by experts, and so after all the net result is in the direction of steady prices).

Remedies.

Remedies which would remove or reduce evils in connection with speculation are greatly to be desired.

Some have advocated the prohibition of future contracts altogether ; but this is not desirable.

So far no really promising and satisfactory remedies have been suggested.

Prof. Taussig mentions the following remedies specially in connection with stock exchange speculation—

(i) revision and enforcement of the rules made by the exchanges for themselves

(ii) publicity in stock dealings ; this however has been tried in Germany without much success ;

(iii) greater regularity of all industry would lessen speculation but this would be at the cost of progress ;

(iv) better public opinion on the subject of speculation would also lessen speculation by outsiders.

The technicalities of speculation. Some terms.

Goods are for immediate or for future delivery. Contracts in which the delivery is to take place at some future time are known as *futures*. Thus we have 'cotton futures,' 'wheat futures' as opposed to '*spot*' cotton or wheat in which the delivery is on the spot and immediate. If the speculator thinks that prices are going to fall in future, he will '*sell short*'—that is, he will engage to deliver at a future time goods not yet in his possession ; and he hopes to make his profit by buying in future at a lower price than the price at which he sells and thus fulfilling his contract.

Of buyers of futures, (a) some are producers who buy a commodity as raw material for the purposes of production, (b) and some are mere speculators who are trying to make a profit only from the differences in buying and selling prices of commodities, shares in companies, etc.

For the convenience of the second class of people, in modern 'future' markets and in the Stock Exchanges for shares, etc., a system of periodic settlements has appeared and with it dealing in *differences*. When delivery of the commodity becomes due, there is no demand for delivery but only for the differences in prices.

Speculators who try to profit by an expected rise of price are called '*bulls*' and those who try to profit by an expected fall are known in the market as '*bears*.' Bulls toss up prices, and bears pull down.

CHAPTER VIII.

SOME SPECIAL PROBLEMS OF VALUATION.

Connected Values. Joint Demand. Joint Supply.

Composite Demand and Composite Supply.

So far the value of a commodity has been studied without any reference to other commodities.

So far we have examined the value of a commodity as determined by its own supply in relation to the demand for it—but as a matter of fact the value of a commodity is dependent upon its own demand and supply and frequently it depends also upon the demand and supply of other commodities, and in this way *the value of a commodity may be and is often connected with the values of other commodities.*

Now we proceed to examine these complex cases of connected values which are to be found very largely in the realm of actual facts. In fact it will be found that very generally, the value of a commodity is connected in some way or other with the values of many other commodities.

Tea and coffee have their values connected ; so also rice and straw ; coal, coke and gas ; and many other things.

Joint Demand.

(Prices of goods which are complementary on the demand side)

~~(Two or more commodities are said to be in joint demand when they are demanded together.)~~ (The various factors of

production (the different kinds of labour, the different forms of capital and organization, etc.) of a commodity are joined together in the joint demand for the commodity and thus there is a joint demand for these factors of production.

There is a joint demand for bricks, timber, metal work, the labour of carpenters, the labour of masons and other kinds of labourers, etc., for the purpose of building a house. There is a joint demand for knife blades and knife handles for the purpose of making knives. Similarly there is a joint demand for the factors of production of any other commodity.)

Direct and Derived Demand. The demand for a house is a direct demand and demand for the factors (*viz.* bricks, timber, steel, and labourers etc.) required in building the house is a derived demand and it is derived from the demand for the house itself.

An interesting case of Joint Demand. *The value of a thing which is jointly demanded with other things depends upon (a) its own demand and supply (b) and also upon the demand and supply of these other things.*

A demand for houses is a joint demand for several factors of production, wood, brick, glass, metals, also for plumbers' labour, plasterers' labour, labour of carpenters, of masons, and all other things required for making houses.

Suppose there is an increase in the demand for houses, and a rise in their price. This increase in the demand for houses will be reflected in the demand for the factors. *The conditions of demand and supply are not generally the same for all factors. Some factors may be practically unlimited in supply and some may be limited in supply. If one factor (e.g. plumbers' labour) is indispensable and also limited in supply, while the other factors are easily procured in large quantities,—this factor will get the greatest advantage from the rise in the price of the commodity (i.e. houses). Let us suppose that the plumbers are able to raise their wages by a check to the supply of their labour; in the first instance the loss will be borne by the employers but then the employers will ultimately distribute a considerable part of this loss among other factors of production*

by dismissing some of the workmen, diminishing the wages of others and in other ways.

The general conditions under which a check to the supply of one factor of production (viz. plumbers' labour) may raise much the price of that factor are the following:—

1. The first condition is that the factor should be essential or almost essential to the production of the commodity and that there is no good substitute for that factor.

The more essential the factor is, the greater will be the possibility of the price of that factor being raised by a check in the supply of that factor, other things being equal.

2. The second condition is that the price of this factor of production should be a small portion of the total expenses of production of the commodity.

If this is so, then even a considerable rise in the price of that factor of production will not raise greatly the total expenses of production of the commodity, and therefore will not raise greatly the price of the commodity; and so the demand for the commodity will not be checked to any considerable extent.

And the demand for the commodity being not checked, the producer of the commodity will be in a position to give if necessary a considerably enhanced price for the factor of production.

3. The third condition is that the supply of other factors of production should be inelastic and that even a small check in the amount demanded should cause a large fall in the prices of other factors of production.

A check in the supply of the factor of production by causing a check in the supply of the commodity will reduce the demand for other factors of production of the commodity; and if this will lead to a great fall in the prices of other factors of production, that will increase the margin available to the producer for paying a high price for this factor of production.

4. *production is such that the demand for it is still and inelastic*

Suppose the demand for houses in a particular town is stiff and inelastic.

The demand for houses being inelastic, a check in the supply of houses will raise the prices of houses greatly. A check in the supply of plumbers' labour (supposing plumbers' labour is essential to the building of a house) will reduce the supply of houses and will thus greatly increase the price of houses; the builders therefore to secure the extra profits from the high prices of houses will compete with one another for the supply of plumbers' labour, and thus the value of plumbers' labour will be raised considerably.

When some or all of the above four conditions are present, a check in the supply of one factor will raise greatly the price of that factor. For example, under these conditions, a combination of labourers (i.e. plumbers) restricting their supply may be able to raise much their wages.

Composite Demand.

The demand for any commodity in the market is composed of the demands of all individuals for that commodity in that market; so the demand of the market is a sort of composite demand.

The expression "*composite demand*" is also used to refer to the total demand for a commodity rising from its various uses; the composite demand for a factor of production rises from the different uses of that factor in different industries. Steel is used in the rail-making industry, the knife-making industry, in the manufacture of fine surgical instruments, and in many other industries; and the composite demand for steel means the total demand for steel rising from the different demands for it in the different industries.)

The case of composite demand rising from the different uses of the commodity is so similar to the case of many consumers demanding a commodity for the same use that it need not be separately discussed.

Joint Supply (Joint Cost).

(Prices of goods which are complementary on the supply side).

As there is a joint demand for certain things, so there is a joint supply of many things.

(When two or more commodities are simultaneously produced in a single process of production with the same joint cost, when they are joined together in a common origin they are said to be joint products; and the supply of them is a joint supply.

Good instances of joint products are (i) gas and coke which have a common origin and are produced simultaneously by the same productive operation from coal, (ii) rice and straw, (iii) mutton and wool, etc.

If among some joint products, one is more important than the rest, that one is called the main product, and the other products are called by-products. (In some cases the by-product in course of time comes to be the chief product—the by-product of to-day may become the main source of profit to-morrow through new inventions or new demands).

The value of joint products is determined by (a) the joint costs and (b) respective demands for the different joint products.

(a) Supply side.

On the supply side, the principle is that the combined prices of the joint products must be sufficient to cover their joint expenses of production—the total value of the joint products (main product and by-products) is determined by the total costs of production.

The combined prices of mutton and wool must cover their joint expenses of production. The combined prices of rice and straw must cover the total expenses of the cultivator. Otherwise the producers will cease to produce.

(b) Demand side.

And the separate prices of the different joint products will be again determined by the separate market demands for these commodities.

The price of rice plus the price of straw must cover the joint costs of both rice and straw ; but the separate price of rice must depend upon the demand for rice and the separate price of straw must depend upon the demand for straw.

Joint supply in the case of gas and coke (C. U. 1929, 1932).

A gas company, producing gas to be supplied to a city, by the same act of production will produce gas and coke as joint products. Gas cannot be produced without producing coke.

The total values of gas and coke together must be sufficient to cover the joint cost of production of gas and coke. If the total values are not sufficient to cover the joint cost, the producer will be losing money and so ultimately the producer will stop production. The separate price of gas will depend upon separate demand for gas in the market and the separate price of coke will depend upon the separate demand for coke in the market.

Let us see what will be the effect of an increased demand for gas on the price of coke. We have to bear in mind that in this case there is only an increased demand for gas but no increased demand for coke. The increased demand for gas will lead to an increased supply of gas, to meet the increased demand. But gas cannot be produced without producing coke. So the increased supply of gas will bring with it an increased supply of coke. The total value of gas and coke will cover the joint cost of production of gas and coke. As regards the separate price of coke with increased supply but no increased demand (as already assumed), the separate price of coke falls.

A 10 p.c. tax on gas.

Suppose a tax of 10 p.c. is imposed on gas. The price of gas will rise and people will be using more electricity and less gas. (The price of gas will rise partly on account of the tax and may be partly on account of the fact that gas being produced under conditions of increasing return a reduced supply of gas will be produced at a greater cost per unit). So the gas com-

pany will be producing less gas. Gas and coke are produced jointly by the same act of production. When the gas company will be producing less gas, it will be producing also less coke. So the supply of coke in the market becomes less when a tax of 10 p.c. is imposed on gas. But the demand for coke has not decreased. Hence the separate price of coke will rise due to decreased supply, demand remaining the same. The total prices of coke and gas (excluding the tax) will cover the total cost of production of the joint products—gas and coke.

Cases of Joint Supply.

We shall have to consider two classes of cases :

(1) *In some cases, the process of production produces quantities of the joint products having a definite and fixed ratio to one another.*

Suppose each ton of cotton seed produces a hundred gallon of cotton seed oil and one-third ton oilcake and meal.

Now the producer must fix the relative prices of these joint products (cotton seed, oil and oilcake) at such figures that there will be market demands for these different commodities in the proportion they are produced.

Take also the case of rice and straw, and suppose the quantities of rice and straw bear a fixed ratio to each other.

An increased demand for rice will lead to an increased supply of rice and also an increased supply of straw. If in the meanwhile there is no increased demand for straw, the price of straw falls to enable the increased supply of straw to be sold.

(2) *And there will be other cases in which the proportion, in which the quantities of the different joint products are produced is not definite and fixed but can be modified.*

When it is in the power of man to modify the proportions in which the joint products are produced, he will modify the proportion in the way which is most advantageous to him.

Suppose a certain quantity of milk yields one pound of butter and one gallon of whey; but if by better feeding of the cow the richness of the milk is increased then with that increased cost the same quantity of milk yields $1\frac{1}{2}$ pound of butter and one gallon of whey.

1lb. of butter	1 gallon of whey	Cost 2 shillings
$1\frac{1}{2}$ lb. of butter	1 gallon of whey	Cost 2 shillings and 2 pence
So the separate cost of $\frac{1}{2}$ lb. butter is 2d.		

In modern times England imports wool from foreign countries and so Englishmen get their wool cheap; and so they have successfully attempted to adapt English sheep in such a way as to make them develop heavy weights of meat even at the expense of some loss to the value of the wool.

Railway rates (for passengers and goods)—*the principle of charging what the traffic will bear.*

The theory of valuation of joint products is applied to railway rates.

All services rendered by railways in connection with passenger as well as goods traffic are joint products; and their joint expenses of production are the total expenses in connection with the working of the railway, these total expenses including (a) cost of loading and unloading and cost of labour and materials as regards any particular load, (b) maintenance of the permanent way and rolling stock and general expenses of railroad staff, (c) payment of interest on bonds etc.

The full cost of production as regards any particular service (e.g. a particular service relating to carrying a particular passenger a certain distance, or the particular service rendered by the railway in carrying a particular consignment of goods) cannot be separately determined.

We can only say that the total cost of production of all the services rendered by the railway is the total expenses of the railway.

The relative prices of the different services produced by the railway are determined in the following fashion:

As the complete separate cost of production of any particular service cannot be separately calculated, *the value of any particular service rendered by the railway or in other words the railway rate for it is not determined by its separate cost of production but according to the principle of charging what the traffic will bear.* The railway rate for any particular service (e.g. the railway rate for first class passenger traffic and for other classes of passenger traffic or the railway rate for different commodities and for different distances) is thus fixed at a figure covering at least expenses (a) and also making the particular traffic bear according to its nature and condition as large a contribution as possible towards expenses (b) and (c).

So in the services rendered by railways as in other joint products

(1) Combined values of all the joint products must cover the total joint expenses of production of the joint products.

(2) The relative prices of the different joint products are determined by the relative market demands for these products (*i.e. by the principle of charging what the traffic will bear*).

On this principle, the railway rates for carrying coal, wood and other bulky goods are low, bulky goods pay their separate expenses and comparatively little for general expenses. Silk has a high price and can afford to pay a higher freight rate, so the rate for carrying silk is high,—silk pays its separate expense and also a comparatively large contribution towards the general expenses of the railways. *Bulky traffic is charged what it will bear, expensive goods are charged at a higher rate because they are able to bear a higher rate.*

In railway rates we have the predominant importance of joint cost and also often we have the element of monopoly. Charging what the

traffic will bear is good if the object is to secure from the railways the maximum service for the community; but charging on this principle becomes a monstrous injustice and a serious menace to society if it is done for the benefit of a monopoly controlling the railways.

Importance of Joint Cost.

The principle of joint cost is of very great influence in modern economic life. The progress of science and the development of large-scale production have led to the utilization of many by-products previously wasted, and so have made the principle of joint cost of wide and increasing importance. *In a large and increasing number of manufactured commodities as in many agricultural and mineral products, the law of joint cost rules....Under modern conditions of industry, cost is coming to mean more and more joint (and not separate) cost.*

Composite Supply.

(Prices of goods which compete on the supply side).

When a thing has several sources of production, it is said to have a composite supply and its total supply is composed of the supplies from all the different sources; these supplies from different sources are rival and competitive supplies, they compete with one another.

The principle of substitution operates as regards the rival supplies; and a prudent man will be substituting each of the supplies for the other ones if that is more economical to him, if by that substitution he gets the required service more cheaply and efficiently. If this process of substitution is carried to its logical limits then *the prices of the substitutes (i.e. rival supplies) will be such that a man for equal expense, purchases an equal amount of satisfaction or service from each of these rival supplies.* (But this is not always possible to the fullest extent in actual life. Men and women often follow custom, fashion—do not always act from strict rational calculation).

Light, for example, may be secured from the use of coal gas, electricity or oil; these different sources produce rival or competitive supplies of light. The prices of these several rival supplies of light are broadly fixed under the operation of the principle of substitution, so that the consumer with equal

expense gets an equal amount of satisfaction from each of these sources.

The rival or competitive supplies may be rival supplies of finished commodities and they may be also rival supplies of factors of production. For example, there are rival fibres used in producing ordinary printing paper.

CHAPTER IX.

SOME THEORIES OF VALUE.

The true theory of value.

It has been seen already that the *true theory of value is that value is governed by utility and cost of production jointly*; and that utility alone without scarcity (due to cost of production or any other cause) will not give value in exchange to a commodity, and again cost of production alone without utility will not give value in exchange to a commodity.

This theory of value is worked out by Prof. Marshall in his *Economics of Industry*, and more fully in his larger *Principles*; and he has been followed with or without modifications by a host of English and American writers.

An account of this theory is given in chapters iii, iv, v of Book IV.

Vilfrid Pareto quoted by Prof. Gide says practically the same thing,—“value is born of the contrast between tastes and obstacles.”

Other theories of value.

There have been many other theories of value *viz.*, utility theory, scarcity theory, difficulty of acquisition theory; but they have some defects or other, and nearly all have been abandoned by recent writers.

1. Utility theories.

(A) ~~The advocates~~ of this theory in one form have held that *value is determined by utility—of two things that one will have the greater value which has the greater utility.*

Criticism of utility theory.

(1) *The value of a commodity is not in proportion to its total utility.* The total utility of salt to a man is greater than the total utility of tea, yet the value in exchange of tea is greater than the value in exchange of salt

(2) Utility alone without limitation of supply will not give value to a commodity. (See in this connection page 366).

The older utility theory was sometimes supplemented by the element of scarcity.

(B) *Scarce utility theory.*

Certain economists (Senior, Walras the elder) have held that *value is determined by scarcity*, and they consider that utility is implied in the idea of scarcity. Prof. Gide criticises these writers, and says that they give scarcity the greatest degree of importance, whereas it is really secondary, utility being of the first importance.

(C) *Final utility theory or marginal utility theory.*

This is an improvement upon the old utility theory discussed above.

The final utility theory first formulated by Dupuit and Gossen was created afresh by Jevons in England, Walras in Switzerland, Karl Menger in Austria, Clark and Patten in the United States. The chief exponents of this theory in Austria include Bohm-Bawerk and Wieser.

The advocates of this form of the utility theory recognise that value is not proportionate to total utility ; they hold that *the value of a commodity is determined by its marginal utility.*

They argue generally in the following manner :—

Value is determined by subjective utility.

The utility of each unit of the commodity possessed by a man is not the same. The utility of each successive unit added to the stock of a man is less than that of the preceding unit : and the utility of the marginal unit is the least of all.

A man will pay a value for the marginal unit equal to the

utility of the marginal unit (*i.e.* equal to the marginal utility of the commodity to him).

In the market each of these units possessed by the man has the same value, because they are interchangeable being of the same quality and quantity.

So the man will pay a value for each unit of the commodity equal to the value he is willing to pay for the marginal unit ; and thus the value of the commodity will be determined by its marginal utility to the man.

Now there are many purchasers of the commodity in the market, and also many sellers of the commodity. Prof. Gide holds that competition between the two parties least willing to conclude a bargain, competition between the buyer least anxious to buy and the seller least anxious to sell determines the market price. The Austrian school calls the buyer least anxious to buy and the seller least anxious to sell the *marginal pair*. (*Grenzpaar). Value in exchange of the commodity in the market thus coincides with final utility in the case of the marginal pair.

(i) *Gide's estimate of the final utility theory.*

This theory is a revival of the older theory of Senior and Walras in a more scientific form. Final utility is, in fact, only the scientific name for the scarce utility.

"The merit of the final utility theory lies in the fact that it has reconciled the two older explanations, utility and scarcity by showing that they are inseparable, and that utility, in the economic sense of the word, varies with quantity; that it is, as the mathematicians say, a function of the quantity.

(ii) *Ely's estimate of the final utility theory.*

Prof. Ely recognises the following elements of usefulness in the final utility theory. "The concept of marginal utility does, however, aid us in understanding the causes of exchange value, because it forms a bridge by which we can pass from definite money units in which exchange values are measured to the indefinite, subjective units of satisfaction in which we measure the utility of goods."

For Cassel's criticism of the marginal utility theory of value, refer to page 366.

* This conception of the limiting couple has its uses, but it is not appropriate in many cases, *e.g.*, where a single individual on one side of the market buys from or sells to a large number on the other side. (For this conception and for the Austrian theory of value, Smart's *Introduction to the Theory of Value* may be consulted).

Criticism of the final utility theory.

(i) *This theory pays attention to demand but not sufficient attention to the supply side of value*—it neglects the influence of cost of production on value in many ways. This is the great defect of the Austrians and other advocates of the final utility theory.

(ii) The advocates of the marginal utility theory say that value is determined by marginal utility ; but they are arguing in a circle, for marginal utility also depends upon value. A man will consume many units of a commodity if its value is small, and so its marginal utility (*i.e.* utility of the marginal unit) to him will be small ; and he can afford to consume only a few units of the commodity if the value of the commodity is great, and in that case the marginal utility (*i.e.* utility of the marginal unit) of the commodity to him will be great. Marginal utility is thus seen to depend upon value.

We have therefore *mutual causation*—value depends upon marginal utility, and marginal utility depends upon value.

II. Cost theories.

(1) Cost of production theory of value.

Some writers have stated that *value in exchange is determined by cost of production* (including cost of labour, cost of raw materials, interest and depreciation on capital, also normal profit of the producer).

They argue somewhat in the following manner :—

If a commodity B has a cost of production double that of C, then the value of B should be double that of C. Otherwise it would not be profitable to produce B. Value of a thing must be in proportion to cost of production.

If the value of a thing is higher than its cost of production competition of rival producers generally tends to bring the value down to the cost of production. When the value is lower than the cost of production, it is not profitable to produce the thing,—so the supply falls off till the value of the thing rises and covers its cost.

According to Ricardo, difference in quantity of labour causes difference in value.

Criticism of cost of production theory.

(i) *Cost of production alone without utility will not give value in exchange to a commodity* ; value in the case of reproducible commodities is governed jointly by utility and cost of production. A theory of value which neglects utility misses the truth, and is absolutely incomplete.

Take the case of a small, highly complex machine with an enormous cost of production (say £10,000), which has no utility at all. Now, what will be the value in exchange of the machine? As the machine has no utility, nobody will give any sum for it. Though the cost of production of the machine is £10,000, yet as it has no utility, it will have no value practically speaking.

(ii) The shorter the period, the greater is the influence of demand (utility) on value ; and the longer the period, the greater is the influence of cost of production on value. So the cost of production theory is incomplete for it does not properly explain short-period value where utility is more important than cost of production.

(iii) Again the cost of production that has got influence on value is generally the marginal cost. This has to be clearly indicated in the theory.

(iv) Again the relation between cost of production and value is not one of cause and effect, but one of *mutual causation*. Cost of production has its influence on value ; but value also has its influence on cost of production. An increase in the value of a commodity (due to an increase in the demand for it) will tend to bring about an increased supply, and the increased supply of the commodity will be at a higher or lower cost of production than before according as the commodity is subject to the Law of Diminishing Return or the Law of Increasing Return.

(v) Utility (demand) is one cause of value, and the other is limitation of supply. *This limitation of supply is brought about by cost of production ; and it may be brought about also*

by other causes, e.g., a monopoly, or a fixed supply which cannot be increased (viz. rare paintings or sculptures by old masters, autographs of distinguished men, etc.). Value on the supply side depends not only on cost of production but on any other cause limiting supply.

(2) Cost of reproduction theory.

The American economist Carey, the Italian Ferrara and some other economists declare that the *value of a commodity at any time is determined* not by its original cost of production but by the *cost of reproduction* of the commodity at the time of sale.

A commodity may have been produced some years ago at the cost of £10 per unit of the commodity ; but suppose at the present moment on account of certain improvements in the processes of production, the commodity can be now reproduced at the cost of £5 per unit, so the cost of reproducing the commodity at present is £5 per unit.

These economists assert that though a certain unit of the commodity may have been produced some years ago at the cost of £10 per unit, yet the value that will be paid now in the market for that unit of the commodity will be not the original cost of production (i.e. £10) of that unit, but the cost of reproducing that unit at the present moment (i.e. £5).

Criticism of cost of reproduction theory.

(i) This theory also does not pay proper attention to the influence exercised by utility on value.

The cost of reproducing a piece of furniture may be £80 ; but if that kind of furniture has grown unfashionable and is no longer in demand, if it has no utility—its value in the market will be nothing, though its cost of reproduction is £80. If the utility of the piece of furniture is small, the value of the piece of furniture will be small, though its cost of reproduction may be great.

(ii) Cost of reproduction exerts little direct influence on value, save when purchasers can conveniently wait for new supplies.

"There is no connection between cost of reproduction and price in the cases of food in a beleaguered city, of quinine the supply of which has run short in a fever-stricken island, of a picture by Raphael...of a cracked bell, of a dress material that has gone out of fashion or of a house in a deserted mining village." (Marshall—*Principles*, Book V, Chapter VII.).

And as regards the theory of normal values, to substitute cost of reproduction for cost of production is to make no real change—for normal cost of production and normal cost of reproduction are convertible terms and mean the same thing.

(3) Labour (labour cost) theory of value.

The labour theory of value occupies an important place in the history of economic thought.

*It is to be found in Adam Smith, it is emphatically, asserted by Ricardo; and Karl Marx, the great socialist leader, based his 'scientific socialism' upon his version of the labour theory of value.

Carey's theory is also a labour theory.

According to advocates of the labour theory, though utility is the condition of value, it is certainly not the cause of value, and only *labour is the cause of value*. *The value of a commodity depends upon the amount of labour required in making it.*

The attractiveness of the labour theory.

This theory is at first sight very attractive on account of the following reasons:

(1) It appears more scientific than the utility theories. It gives as the foundation of value a precise, objective, quantitative notion (viz. labour), something that can be measured.

* "Labour, therefore, is the real measure of the exchange value of all commodities"—Adam Smith, *The Wealth of Nations*, Book I, chapter V.

"This (i.e. labour) is really the foundation of the exchangeable value of all things"—Ricardo, *Principles*, Chapter I.

"We see then that which determines the magnitude of the value of any article is the amount of labour socially necessary or the labour-time socially necessary for its production"—Karl Marx, *Capital*, Part I, chapter I.

(2) It satisfies our sense of justice more fully than other theories because it bases value upon labour—it seems equitable that the values of different commodities should be proportional to the different amounts of labour required for them.

Gide's criticism of the labour theory of value.

Prof. Gide in his *Political Economy* puts forward the following objections against the labour theory :

I. From the moral standpoint, the labour theory is not so satisfactory as it appears at first sight. Labour, when it is useless, and produces nothing cannot pretend to moral value.

(As against this objection of Prof. Gide, it may be said that labour itself, the mere effort has moral value though it may produce little or no wealth in a particular case.

II. From the scientific standpoint, the objections against the labour theory are even stronger.

(i) If the value is supposed to be based upon the *labour* spent in producing the commodity (*i.e. past labour*), then the value of the commodity ought to be unchangeable, because the amount of past labour (*i.e. the labour already spent in producing the commodity*) is unchangeable, not changing with variation in demand.

We however all know that the value of a commodity is changeable, changing with variations in the demand for it.

To meet this objection, it has been said by some supporters of the labour theory of value, that *value is determined* not by past labour but by *present* (*i.e., the labour required in reproducing the commodity at present*). "But, in that case, we are no longer speaking of labour as a constituent element of value, but of labour as a measure of value—quite a different matter."

(ii) If labour were the cause of value, then for equal amounts of labour there should be always equal values and for unequal amounts of labour unequal values. This however does not always happen.

Two things which cost the same amount of labour will often sell at different prices.

Again we often find two things which have cost unequal amounts of labour (e.g. a maund of wheat growing on less fertile land and therefore costing more labour and another maund of wheat grown on more fertile land and therefore costing less labour) will sell at the same price in the market.

(iii) If labour be the cause of value, when there is no labour, there would be no value. In actual fact, however, we often find a thing having value because it has utility though no labour has been spent in producing that thing. A mineral spring without any labour has value because it has utility ; and this is also the case with meteoric iron, guano deposited by sea-birds, etc.

Briefly we may sum up the case against the labour theory of value by saying that *the value of a commodity is determined not simply by the labour required for it, but that the value of a commodity is jointly governed by utility and limitation of supply (due to cost of production or other causes) ; and cost of production includes many elements of which labour is only one.*

Marx's Theory of Value—the Socialist Theory of Value.

Karl Marx was the most learned socialist thinker of the nineteenth century—and he used the labour theory of value with a purpose different from that of Adam Smith and Ricardo. Adam Smith and Ricardo supported the existing system of distribution of wealth ; *Marx used his version of the labour theory of value to attack the existing distribution of wealth, and to give a supposed scientific basis to socialism.*

*Karl Marx declares that *"that which determines the magnitude of the value of any article is the amount of labour socially necessary or the labour-time socially necessary for its production."* The 'socially necessary labour-time' is the time

* Karl Marx—*Capital*, Part I, Chapter I.

Marx adds "As values, all commodities are only definite masses of congealed labour-time" and "The value of a commodity varies directly as the quantity and inversely as the productiveness of the labour incorporated in it." Each individual commodity, in this connection, is to be considered as an average sample of its class.

required by the average labourer under the existing social conditions,—the labour-time socially necessary is that required to produce an article under the normal conditions of production, and with the average degree of skill and intensity prevalent at the time. The theory is that labour produces all value, labour costs constitute the 'natural values' of things and so *commodities should have values in proportion to the labour required for them*. (Marx's conclusion from the labour theory of value is that as the entire value of a commodity is due to the labour producing it, the entire value of the commodity should go to labour; and therefore that part of the value of the commodity which goes in a modern society as interest and rent to the capitalist and the landlord means so much robbing of the labourers by the capitalist and the landlord. Marx wants the abolition of private property in land and capital; there would be then no private capitalists and landlords appropriating interest and profits and thus robbing labourers, and so the entire value of the commodity will go to the labourers producing it. So Marx's theory is an attack upon the capitalist and the landlord classes, and an attack upon the existing distribution of wealth).

Criticism of the Marxian theory of value.

(1) In the first place *Marx's theory is one-sided and incomplete because it neglects utility*. Marx says that value is due only to labour, and values of things are to be measured by socially-necessary labour-time required for the production of these things. As a result of this theory, the free gifts of nature cannot have value for they have not cost any labour; but as a matter of fact, such free gifts of nature as are limited in supply have value for they have utility.

(2) It has been already pointed out that value in the social order as it is constituted (and not in the ideal socialist state of Marx) is jointly governed by utility and cost of production; and cost of production includes many elements (*e.g.* interest and depreciation on capital, profit for the organizer, etc.) of which labour is only one. *It will be therefore incorrect to hold that value is governed only by labour cost and not by other costs.*

[Again as regards labour costs, there are differences in the quality of labour ; and the labour of the poet, the labour of the artist, and the labour of the common coolie (unskilled workman) cannot be reduced to a common basis of labour time as wanted by Marx.]

(3) Critics of the Marxian theory of value declare that Marx tells us what he thinks value *ought* to be whereas the function of a scientific theory of value is to explain values that *really exist*.

They also say that the Marxian theory of value is open to the further objection that in stating that the values of commodities ought to be in proportion to their labour costs, it practically assumes what it has to prove *viz.* that private property in land and capital should be abolished.

A note on the theory of value.

*Value is the central theory of modern economic science as usually taught in England and the United States of America. A brief account of the development of this theory in England, and how it has come to occupy its present position of importance is outlined below.

†Adam Smith.

Adam Smith did great work in developing the theory of Free Trade ; but *important also was his work in connection with the theory of value*. He was the first to make a careful and scientific inquiry into the manner in which value measures human motives (a) on one side measuring the desire of buyers who desire to purchase commodities (b) on the other side measuring the efforts and sacrifices of the producers, those who produce and sell the commodities.

†Ricardo.

The next great name is that of Ricardo. In his exposition of value Ricardo gave his main attention to *supply and cost of production* and

* It has been pointed out already (Book IV, Chapter III) that the importance of the theory of value as the central theory of Economics is naturally more widely recognised in countries where exchanges and markets are highly developed than in countries and in times where exchanges and markets are not so developed.

† Marshall—*Principles*, Appendix I.

‡ Utility then is not the measure of exchangeable value ; although it is absolutely essential to it. Possessing utility, commodities derive their exchangeable value from two sources ; from their scarcity, and from the quantity of labour required to obtain them. *That this (i.e.*

in this he displayed remarkable originality and genius. He did not pay sufficient attention to demand and utility; "he took utility for granted, because its influence is relatively simple."

Jevons and the Austrian writers.

Ricardo was one-sided in his emphasis upon supply and cost of production; *Jevons* was even more one-sided in his exaggerated emphasis upon demand and final utility.* Ricardo somewhat neglected demand, Jevons and the Austrians neglected supply.

J. S. Mill.

Mill's work came before that of Jevons. For a whole generation, Mill's influence was paramount, almost monarchical in the domain of economic thought. *And in his theory of value, Mill claimed to have attained finality.* "Happily there is nothing in the laws of Value which remain for the present or any future writer to clear up; the theory of the subject is complete."

In spite of Mill's claims to finality, his theory of value has been sharply criticised.† His work (as compared with that of Adam Smith, Ricardo and his followers) had many of the essentials of a finished picture but *still it was transitional and not final.*

He did not pay sufficient attention to the influence of demand, Mill's emphasis was on cost of production and supply.

He did not clearly realize the close connection between the theories of domestic and international value, and he seemed to have no idea of the intimate relation and fundamental similarity between the theory of distribution and that of value.

(His study of markets, of cost of production, of market and normal prices was also incomplete).

‡ Alfred Marshall.

Marshall, the greatest English economist of the present generation, has developed the work of Mill and his predecessors. His great contributions to the theory of value are the following :

labour) is really the foundation of the exchangeable value of all things, excepting those which cannot be increased by human industry, is a doctrine of the utmost importance in political economy (Ricardo—Principles, Chapter I).

* Jevons—*Principles of Economics.*

† Cairnes—*Some Leading Principles.*

‡ Alfred Marshall and his work.

P. T. Homan in his *Contemporary Economic Thought* gives a competent and appreciative survey of Marshall's economic work, also notices some of the criticisms in connection with Marshall's economic doctrines.

(1) Jevons's emphasis was on demand and utility, Ricardo's and also Mill's emphasis was on cost of production and supply; *Marshall has combined demand and supply, utility and cost of production in the determination of value* and he has introduced the mathematical conception of *mutually determining influences* and how demand and supply and value are mutually determined.

"As Marshall summarizes the mechanism of his system, the theory of value traces "a continuous thread running through and connecting the applications of the general theory of the equilibrium of demand and supply to different periods of time; from those so short that cost of production could exercise no direct influence on value, to those so long that the supply of the appliances of production could be fairly well adjusted to the indirect demand for them, which is derived from the direct demand for the commodities which they produce" (*Principles of Economics*, p. 545. The phrase is wrested from the context). "The theory of distribution applies the value theory to the various agents of production. It is "concerned with another thread of continuity, which lies transversely to the thread connecting different periods of time. It connects the various agents and appliances for production, material and human; and establishes a fundamental unity between them, in spite of their important differences of outward feature." (*Ibid.*, p. 660).

"This body of theory, extending, modifying, and developing the classical doctrines, constitutes the main doctrinal content of the neo-classical school of economic theory, of which Marshall may be considered the founder. Like the classical writers, Marshall centers his analysis about the problem of exchange values The vital center of his system of thought consists of an extension of the notion of the equilibrium of demand and supply, to the end of demonstrating the complete interdependence of the price system, and the fundamental unity in principle of all economic values. The whole economic order is made to appear as a sort of "solar system of balance and counterpoise," held together in a "fundamental symmetry."

In displaying this picture of economic symmetry, Marshall's principal tool is marginal analysis, particularly the principle of substitution at the margin. With the aid of this tool he accomplishes a convincing presentation of the forces which regulate the demand for commodities and the supply of them; which elicit the supply and adjust the uses of the various factors of production; and which determine the prices of commodities and the incomes of persons. The all-embracing unity of his thought is most clearly apparent in the enlightening idea that the agents of production are simultaneously rivals for employment and the field of employment for other agents. It is apparent, also, in the conception of the national dividend as at once the total product of a country and the total source of demand for products.

. . . . Yet today, there is hardly a single concept, assumption, or doctrine of his system that is not under attack, from one quarter or another.

. . . . Marshall's work is not, however, ready for the *requiem* and "taps." It is imbedded in most of the economic theory upon which the present generation of students is being raised.

. . . . It may be possible to place the implications of Marshall's system in a stronger light by raising certain questions: Can the term

(2) And most important of all, Marshall definitely and permanently established value as the central theory of Economics—in his *Principles*, Book III deals with Consumption (Demand); Book IV deals with Production (Supply); in Book V Demand and Supply are brought into

"utility" do service for both "desire" and "satisfaction"? Does he not tacitly assume a high degree of rationality in men as a basis of his reasoning? Can money serve at once as a measure of motive and a measure of satisfaction, even for homogeneous groups? Can any approximation to equality between money costs and "real" costs be properly assumed? Can the equilibrium of prices be assumed to represent roughly an equilibrium of "real" forces, of human desires and human distaste for further effort? Is competition the principal regulator of economic activity? Are the processes of change sufficiently regular to permit even a rough equality between prices and money costs? Can a system developed by deductive reasoning be made compatible with his views on the biological character of social change? Is modern business properly to be treated from the point of view of production rather than of acquisition? Does the conception of normal equilibrium of supply and demand furnish an adequate basis for investigating modern economic problems, even those of prices and incomes? Is the "representative-firm" adequate for explaining the relation between costs and prices? Are there not innumerable incomes based upon privilege or special advantage of one sort or another that do not fall within the conventional categories? Is the idea of normal profits and normal wages tenable in the modern world? Are the ideas of equilibrium and of normality applicable in any scientific sense to the life of society? . . .

. It really is of secondary importance how permanent or how "true" his theoretical system is. It is of much more moment that Marshall's intellectual powers, amounting to genius, should have been brought to bear upon an analysis of the functioning of the economic system. Time may, as he apprehended, render his theories obsolete. But time cannot change the fact that his insight has illuminated many problems; or that his scientific integrity has been the model and the inspiration of a new generation of economists; or that his humane spirit has speeded the search for ways and means to cope with the pressing problems of modern economic life."—*Contemporary Economic Thought*, 1928, pages 262-277.

Marshall wrote for his own generation. He was a great economist. Also a great man by virtue of his extreme intellectual sincerity and burning social passion. He could not fail to realize that there was no finality in economics, in any social science, in any branch of human knowledge. He never claimed finality for his own economic work. When once he gave a copy of his famous book to a pupil, inscribed "To—, in the hope that in due course he will render this treatise obsolete," this was not a piece of mock modesty (*Memorials of Alfred Marshall*, page 58).

Writing during the World War to Prof. C. R. Fay and speaking about the future, Marshall remarks "1920-1970 will, I expect, be the time for historians.

It drives me wild to think of it. I believe it will make my poor *Principles*, with a lot of poor comrades, into waste paper"—*Memorials of Alfred Marshall*, pages 489-490.

relation with each other and the balancing of Demand and Supply and Value are discussed; the same theory of value as applied to commodities in Book V is applied to the valuation of services (of Land, Labour, Capital and Organization) in Book VI on Distribution—Consumption, Production, Value of commodities and Valuation of services (Distribution) are thus found in Marshall as mutually related and dependent parts of Economics, (and not as isolated, unconnected departments as in the earlier writers). *He has given a unity to Economic Science which it did not formerly possess. Value is the central theory of the Science applicable to the exchange of commodities and of services in domestic, and international markets.*

Marshall's exhaustive and illuminating study of markets, of market and normal values when different periods of time are taken into consideration, and his acute analysis of cost of production are other important and noteworthy contributions to the theory of Value.

This is the substance of what the followers of Marshall say as regards Marshall's work in value theory.

(Refer to *Memorials of Alfred Marshall* for a careful study of Marshall's work in economic theory by J. M. Keynes, a distinguished and enthusiastic Marshallian).

